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INCOME TAX

NEW LEGISLATION

House Bill 5798

House Bill 5798 amends Section 527(a) of the Income Tax Act. The bill allows the Department to establish a program for direct payments of energy drafts to enrolled heating providers. If a claimant's name has been submitted by the provider and meets the requirements established by the Department, the energy draft will be paid directly to the provider.

Revenue Administrative Bulletin 2004-01 **Approved April 5, 2004**

This Bulletin describes the procedures for filing composite income tax returns by flow-through entities with business activity in Michigan and nonresident members in light of the enactment of recent legislation establishing composite filing provisions in the Michigan Income Tax Act.

FORMS

Income Tax Forms

The Michigan Department of Treasury has eliminated the MI-1040EZ and the Telefile booklets for tax year 2004.

The format of the 2004 MI-1040 has changed to facilitate scanning. A copy of the nonresident and part-year resident schedule (Schedule NR) is included in the income tax instruction booklet.

Direct deposit of Michigan income tax refunds is available. Information required to request the direct deposit of a refund is in the instruction booklet

Income tax forms will be mailed out using peel-off address labels. Use the preprinted address labels only when all the information is correct. The social security number on the label is encrypted to protect the taxpayer's privacy. Write the taxpayer's social security number on the return even if you are using the label.

Substitute Forms Must Be Approved

The Michigan Department of Treasury accepts substitute tax forms that meet the requirements of Treasury's Policy ET-03066 Substitute Printed, Computer-Prepared, and Computer-Generated Tax Forms and Schedules.

A copy of Treasury Policy ET-03066 is available on the Treasury Web site at www.michigan.gov/treasury or by calling Forms and Document Services at (517) 373-8891.

Before releasing software to preparers, developers must submit forms for review and receive official approval from Forms and Document Services, Department of Treasury. Approvals are granted for one year only.

Forms filed with the Department that are not approved will be returned to the taxpayer.

Practitioners who purchase software programs should verify that the developer has received Treasury approval of their forms.

The following forms do not require Treasury approval:

1. Photocopies of an original form or of an unaltered reproduction master form provided by Treasury.
2. Forms printed using an unaltered reproduction master form provided by Treasury.
3. Computer-prepared forms in which the taxpayer's information is imaged onto an official form.

Tax forms are available on the Treasury Web site at www.michigan.gov/treasury.

Mailing Addresses

All **computer-generated** MI-1040 and MI-1040CR-7 forms (with or without a barcode) should be mailed to the following addresses:

MI-1040:

For refund, credit or zero returns, mail to:

Michigan Department of Treasury
P.O. Box 30726
Lansing, MI 48909-8226

To pay tax due, mail the return to:

Michigan Department of Treasury
P.O. Box 30727
Lansing, MI 48909-8227

MI-1040CR-7:

Mail the MI-1040CR-7 HOME HEATING CREDIT CLAIM to:

Michigan Department of Treasury
P.O. Box 30726
Lansing, MI 48909-8226

FEDERAL/STATE AND STATE-ONLY ELECTRONIC FILING PROGRAM

Over 60 million people nationwide know e-file is the way to go! This year Michigan was second in the nation only to California in the number of e-filed returns. We experienced a 63% increase in e-file this year. Thank you for making e-file a success.

The Michigan Department of Treasury and the Internal Revenue Service (IRS) continue to work together to provide tax preparers with an efficient method of filing their clients' individual income tax returns electronically (e-file).



The Michigan Department of Treasury has mandated the electronic filing of income tax returns for preparers with 200 or more clients. As a practical matter, the Department views this opportunity as a cooperative venture between Treasury and preparers, the taxpayers you service, software developers, the IRS and other states. This is part of a nationwide effort to increase participation in electronic filing.

For tax year 2003, 95% of the taxpayers who filed error-free e-file returns received their refunds in seven days. Taxpayers who e-file will continue to receive faster refunds in an environment where it may take several months to process a paper return. In addition, the software checks the computations before transmission, thereby eliminating data entry mistakes by the filer or data entry operators. The Department of Treasury also acknowledges receipt of transmitted data within 48 hours, overcoming concerns of paper returns being lost in the mail or misplaced. When e-filing federal and state returns together, much of the same data is used so information is entered only once, again lessening the possibility of error.

The Department fully understands that e-filing may be an adjustment for some taxpayers. It is hoped preparers will focus on the positive promotion of e-filing as a service they offer in addition to quality tax advice and preparation. The Department of Treasury plans to market this program through news releases and advertising information in our instruction booklets and participating in seminars.

There are many benefits to preparers who participate in the e-file program:

- **Convenient.** Both federal and state returns can be filed together in one transmission or the State return can be filed separately (State-Only e-file).
- **Accurate.** Treasury processes the same data that the preparer enters into the computer. The computer program checks for math errors. If an error occurs on a return, the e-file software sends an error message so the preparer can immediately correct the mistake. E-file returns have two-thirds lower error rate than paper returns.
- **Secure.** Only the preparer and client see the return. The tax information is encrypted and transmitted over secure lines.

- **Faster Refunds for error-free e-file returns.** E-file returns selected for review or those with problems will take longer to complete processing. In addition, all paper returns will take considerably longer to process. Clients can also choose Direct Deposit and have their refunds electronically deposited into their accounts at the financial institution of their choice.
- **Quick Confirmation.** The preparer receives an acknowledgement from Michigan one to two days after the IRS acknowledgment.
- **Customer Service.** Preparers will gain customers interested in having their tax returns e-filed.

Treasury can offer preparers who e-file the following services:

- Preparers who are authorized e-file providers can have their name, address and phone number included on Treasury's Web site. This is a benefit to preparers and to taxpayers looking for a preparer who offers e-file. The IRS also offers this service.
- Treasury staff can see immediately if the taxpayer has granted authorization to discuss the return with the preparer. The delays of ordering paper returns and mailing correspondence are eliminated.
- Preparers are given a fax number to supply additional return information when necessary.
- Faster processing for error-free e-file returns. E-file returns selected for review or those with problems will take longer to complete processing. In addition, all paper returns will take considerably longer to process.

How Fed/State Electronic Filing Works

Tax preparers and transmitters accepted in the IRS e-file program may participate in the Fed/State e-file Program and file both the federal and state returns together in one transmission to the IRS Service Center. The IRS will acknowledge acceptance of the federal return. The state data will then be made available for retrieval by the Michigan Department of Treasury. After the data is retrieved, it will be acknowledged and processed by Michigan.

If the Michigan return is rejected, it can be retransmitted as a State-Only return. If the software does not allow for State-Only e-file, the preparer can fax the Michigan MI-1040 and accompanying attachments to the Alternative Filing Programs Office. Electronically-filed returns are subject to the same audit checks as paper returns.

How State-Only Electronic Filing Works

Michigan's State-Only e-file program is a cooperative effort with the IRS. The tax preparer will have to indicate in the software that it is a State-Only filing. Michigan will accept State-Only returns with or without an MI-1040. State returns will be transmitted to the IRS and the IRS will validate the Social Security number against the name and issue an acknowledgment. If the return passes validation, the State data will be made available for retrieval by the Michigan Department of Treasury. After the data is retrieved, it will be acknowledged and processed by Michigan.

State-Only returns may be signed electronically. Only those taxpayers that filed MI-1040, MI-1040CR, MI-1040CR2 or MI-1040CR7 returns in the previous tax year are eligible to use the electronic signature alternative.

Who May Participate

E-filing of Michigan returns is available to all electronic filers who were accepted into the federal e-file program and who transmit returns to an IRS Service Center. Practitioners who prepare 200 or more Michigan income tax 1040 returns and credits are required to e-file these forms.

Application Process

To participate, applicants must first apply to the IRS by submitting form 8633 APPLICATION TO PARTICIPATE IN THE IRS E-FILE PROGRAM and be accepted. Form 8633 is available on the IRS Web site at www.irs.gov.

Publications 1345 and *1345A* specify the application process and requirements for federal participation. The definitions used by the IRS of the various categories of electronic filers, electronic return originators (EROs), transmitters or software developers also apply for Michigan e-filing purposes.

Upon receipt of completed form 8633 the IRS Service Center assigns an Electronic Filer Identification Number (EFIN) and, if applicable, an Electronic Transmitter Identification Number (ETIN) to the applicant.

After receiving the federal acceptance information, applicants are automatically accepted into the Michigan e-file program. Their names and addresses will be included on Treasury's Web site listing of authorized e-file providers located at www.MIfastfile.org. Preparers should contact the Alternative Filing Programs Office at [www.MIefile2D@michigan.gov](mailto:MIefile2D@michigan.gov) if they would like their information removed from the Web site listing.

Acceptance Process

Treasury may conduct a suitability check on applicants who have been accepted in the Fed/State e-file program. Participation in the program may be denied if a company is not registered to conduct business in Michigan, or if there is an outstanding tax liability with Michigan.

The Michigan Department of Treasury will use the e-file Identification Number (EFIN) assigned by the IRS in the Fed/State e-file program. Michigan does not assign any additional identification numbers.

To participate in the e-file program, electronic filers must use software that has successfully completed the IRS and Michigan Participant Acceptance Testing System (PATs). Confirm that the software chosen was approved for Michigan and that the Michigan e-file program is operational before transmitting returns.

A list of approved software companies is available on Treasury's Web site. Tax preparers are not required to file test returns with Michigan.

If after acceptance, a preparer/transmitter or software company has production problems, Treasury reserves the right to disapprove that preparer/software company for part or all of the remainder of the filing season.

Michigan Portion of the Electronic Return

The Michigan portion of an electronic return consists of data transmitted electronically and the supporting paper documents. The paper documents contain information that cannot be transmitted electronically.

Electronic Michigan Returns

The following forms and schedules may be e-filed:

- MI-1040 Michigan Income Tax Return
(Required for all Fed/State e-file returns; not required for State-Only e-file returns.)
- SCHEDULE 1 Additions to and Subtractions From Income
- SCHEDULE NR Nonresident and Part-Year Resident Schedule
- MI-1040CR Homestead Property Tax Credit Claim, **or**
- MI-1040CR-2 Homestead Property Tax Credit Claim for Veterans and Blind People
- MI-1040CR-5 Farmland Preservation Tax Credit Claim
- SCHEDULE CR-5 Schedule of Taxes and Allocation to Each Agreement
- MI-1040CR-7 Home Heating Credit Claim
- SCHEDULE CT College Tuition and Fees Credit
- MI-1040D Adjustments of Capital Gains and Losses
- MI-1040H Schedule of Apportionment
- MI-1310 Claim for Refund Due a Deceased Taxpayer

- MI-2210 Underpayment of Estimated Income Tax
- MI-4797 Adjustments of Gains and Losses From Sales of Business Property
- MI-8839 Qualified Adoption Expenses
- 4013 Resident Tribal Member Annual Sales Tax Credit
- W-2 Wage and Tax Statement
- 1099 form(s)

Note: The information from the W-2 and 1099 forms is entered in the software and transmitted with the e-file return. Do not mail W-2 and/or 1099 forms to Treasury. All W-2 and 1099 information, when applicable, is required when submitting a State-Only return. The IRS is no longer accepting 1099G information within an e-filed return. Therefore, the 1099G information will not be required with the e-filed Michigan return.

- Federal forms and schedules.

Nonelectronic Portion of Michigan Returns

The nonelectronic Michigan return consists of the following supporting documents:

- Copies of state returns other than Michigan for out-of-state credit. Copies should be retained in the taxpayer's records.
- Form MI-8453 MICHIGAN INDIVIDUAL INCOME TAX DECLARATION FOR ELECTRONIC FILING. For Fed/State e-file Treasury does not require that form MI-8453 be mailed. Treasury recommends preparers keep the MI-8453 on file for six years.
- Form MI-1040-V MICHIGAN E-FILE PAYMENT VOUCHER. If tax is due on an e-file return, the taxpayer must submit payment by check or money order by April 15, 2004 with form MI-1040-V. In late March, taxpayers will receive a reminder notice if payment has not been made. If full payment is not submitted by April 15, the taxpayer will receive a bill with applicable penalty and interest. Do not use this form for any other payments to the State of Michigan.
- Michigan does not participate in an electronic funds withdrawal process for tax due returns. All e-file payments must be mailed to Treasury along with a copy of form MI-1040-V.

Michigan e-file Signature Process

For Fed/State Returns:

Michigan will accept the federal signature (federal 8453 or PIN). Michigan does not require any additional signature documentation. If the taxpayer chooses to complete the MI-8453, Treasury recommends that the preparer retain it for six years. **Do not** mail the MI-8453 to Treasury.

For State-Only Returns:

State-Only returns that are filed by a preparer with or without a Michigan income tax return (MI-1040) can be signed using “shared secrets” or the MI-8453 signature document. The shared secrets consist of the Social Security number(s), previous year’s adjusted gross income (AGI) or household income (HHI), and the previous year’s tax due or refund amount. If the MI-8453 is used, the preparer may retain a copy of the MI-8453. The MI-8453 should not be mailed to Treasury.

Note: If the return is signed using shared secrets and the return is rejected because the shared secrets do not validate, the taxpayer/preparer may correct the shared secrets information and retransmit. There is no limit on how many times a State-Only return can be retransmitted in this circumstance.

Exclusions From e-file

When the following forms are included in a filing, the MI-1040 **can** be e-filed, but the forms listed below must be mailed.

- MI-1045 Application for Michigan Net Operating Loss Refund
- 4 Application for Extension of Time to File Michigan Tax Return Returns

When the following forms and/or taxpayer conditions exist, the taxpayer is not eligible for e-file for the 2004 tax year:

- Returns or forms listed as excluded in IRS Publication 1345
- MI-1040 Michigan Income Tax Return if certain taxpayer conditions exist:
 - Fiscal year filers
 - Prior year returns
 - Not required to file a federal 1040 if filing Federal/State
 - MI-1040X Amended Michigan Income Tax Return
 - 3581 Historic Preservation Tax Credit
 - MI-1040CR-5 Michigan Farmland Preservation Tax Credit with more than 25 agreements
 - MI-1040CR-5 for Property Development Rights
 - MI-1040CR-5 and there is a joint agreement and the apportionment is not equal for all partners.

Refund Returns

Direct Deposit information is part of the electronic record; therefore, a separate form 3174 DIRECT DEPOSIT OF REFUND does not have to be completed for e-file. However, remember that the Direct Deposit information for the federal and state returns can be different. This is especially important when the taxpayer has a Refund Anticipation Loan (RAL). The federal refund will repay that loan, but the state refund must be deposited into a different account.

The Michigan Department of Treasury **cannot** make any changes to Direct Deposit information after the return is transmitted.

For More Information

Visit the federal and Michigan Web sites for more information on the Fed/State e-file Program:

www.irs.gov and
www.Mifastfile.org

or call the Michigan TeleHelp system at 1-800-827-4000, topic numbers 171 and 181.

Deaf, hearing-impaired, or speech-impaired persons using a Teletypewriter (TTY) should call (517) 636-4999 for assistance. **This number is reserved for persons using a TTY.**

IRS Mentor Program

The IRS maintains a listing of preparers who have volunteered to mentor others who are new to the e-file program. For more information about the IRS mentor program, call (313) 628-3700. For general information about the IRS e-file program, call 1-866-255-0654.

2-D BARCODING

Treasury will again accept 2-D barcodes for the MI-1040 INCOME TAX RETURN and MI-1040CR7 HOME HEATING CREDIT CLAIM for the tax year 2004. Treasury will also continue to scan 2-D barcodes on prior year returns back to tax year 2000.

New for Tax Year 2004

The 2-D barcode will no longer print directly on the MI-1040 and MI-1040CR-7 forms. Instead, a separate barcode data sheet will be created. The data sheet will only be created when the taxpayer's return includes the MI-1040 and/or MI-1040CR-7 and barcoding supported by the software vendor. The taxpayer name and address on the barcode data sheet must replicate the data provided on the MI-1040 and/or MI-1040CR-7.

This is an opportunity to improve service to Michigan taxpayers. Benefits include:

- Increased accuracy of data capture - barcode scanning is 100% accurate; data entry errors are eliminated.
- Quicker access to taxpayer data - this is especially important for Treasury Customer Service staff who can respond immediately to tax preparer and taxpayer questions.
- Fewer calculation errors - software does the computations.
- Reduced processing - saving Michigan taxpayer dollars.

Check with your software company to see if it will provide 2-D barcoding for Michigan returns.

The 2-D barcode for the MI-1040 will include information from the following forms:

- MI-1040 Michigan Income Tax Return
- SCHEDULE 1 Additions to and Subtractions From Income
- SCHEDULE NR Nonresident and Part-Year Resident
- MI-1040CR Homestead Property Tax Credit Claim, **or**
- MI-1040CR-2 Homestead Property Tax Credit Claim for Veterans and Blind People
- SCHEDULE CT College Tuition and Fees Credit
- MI-1040CR-5 Farmland Preservation Tax Credit Claim
- MI-8839 Qualified Adoption Expenses
- MI-2210 Underpayment of Estimated Income Tax
- W-2 forms
- 1099 forms

The 2-D barcode for the MI-1040CR-7 will include information from the CR-7 form and form 3174 DIRECT DEPOSIT OF REFUND, if direct deposit is part of the taxpayer's filing.

Please note that the Michigan Department of Treasury has mandated the electronic filing of income tax returns for preparers with 200 or more clients. Taxpayers who e-file error-free returns will continue to receive fast refunds in an environment where it will take considerably longer to process a paper return.

To learn more about 2-D barcoding, visit the Federation of Tax Administrators Web site at www.taxadmin.org.

SUMMARY OF CHANGES FOR 2004

Tax Rate	3.95%
Personal Exemption	\$ 3,100
Special Exemption	\$ 2,000
Child Care Deduction	\$ 600
Pension Deduction	\$38,550 Single, \$77,100 Joint
Senior Interest, Dividend and Capital Gains	\$ 8,595 Single, \$17,190 Joint

Estimates - Safe harbor for taxpayers with income of \$150,000 or more for joint or single filers (\$75,000 or more for married filing separately filers) must equal 90% of the current year's liability and 110% of the prior year's liability.

SUMMARY OF CHANGES FOR 2003

Tax Rate	4.0%
Personal Exemption	\$ 3,100
Special Exemption	\$ 1,900
Child Care Deduction	\$ 600
Pension Deduction	\$37,710 Single, \$75,420 Joint
Senior Interest, Dividend and Capital Gains	\$ 8,408 Single, \$16,815 Joint

Estimates - Safe harbor for taxpayers with income of \$150,000 or more for joint or single filers (\$75,000 or more married filing separately filers) must equal 90% of the current year's liability and 110% of the prior year's liability.

FILING REQUIREMENTS

Filing an MI-1040 Return

An individual must file a Michigan return if he or she was a Michigan resident all or part of the year and filed a federal return. A nonresident of Michigan is required to file a return if all or part of his/her income was earned in Michigan or is from Michigan sources.

A nonresident or part-year resident must attach Schedule NR which allocates income to Michigan and/or the state of residence.

Factors to Determine Domicile

A person who is domiciled in Michigan is a Michigan resident. Domicile means the fixed and permanent home to which a person, wherever temporarily located, always intends to return. A person may have several residences but may only have one domicile at a time.

Domicile, once established, is not lost until there is a concurrence of all the following:

1. The specific intent to abandon the old domicile
2. The intent to acquire a specific new domicile
3. Actual physical presence in the new state of domicile. Generally, the domicile of the wife follows that of the husband.

Factors to be considered in determining a taxpayer's residency or domicile include where he or she keeps his or her most important possessions, houses his or her family, votes, maintains club or lodge memberships, buys automobile licenses, maintains a mailing address and banks, operates a business, or sues for divorce. However, no one of these factors is controlling.

Nonresident Aliens

Nonresident aliens must file a Michigan income tax return if their federal adjusted gross income is more than their Michigan exemption allowance. A copy of the US1040NR including all schedules and worksheets must be attached to the MI-1040.

Wages or other income received by a nonresident alien working in Michigan are subject to the Michigan income tax as provided for in MCL 206.110(2). However, due to tax treaty considerations between the United States and other countries, wages and other income received by a nonresident alien living and working in Michigan may not be subject to the Michigan income tax.

See Federal Publication 901 for information on U.S. tax treaties with other countries.

A nonresident alien must file a US1040NR. This return reports all income received by the nonresident alien reduced by wages or other income that is exempted by a United States tax treaty.

Treaty income excluded from adjusted gross income is not subject to the Michigan income tax. A nonresident alien is not considered to be domiciled in Michigan and, therefore, may not claim a homestead property tax credit.

Taxability of Income Derived Within Indian Country

Where the Resident Tribal Member Tribe Does Not Have an Implemented Agreement with the State of Michigan

An individual who is a resident of Michigan and has income from Michigan sources is required to file a Michigan income tax return in accordance with MCL 206.315(1). This provision requires every person who is required to file a return under the IRC to file a return under the Michigan Income Tax Act if his or her adjusted gross income is in excess of the personal exemptions allowed under the Act.

An exception exists for an enrolled member of a federally recognized Indian Tribe or Band located in Michigan where the taxable income is attributable to their activities occurring within their own Indian country (as defined by 18 USC 1151). Enrolled members must also reside primarily within their Tribe's Indian country for such income to be exempt from Michigan income tax.

Although the State cannot require tribal members to file a Michigan income tax return if all of their income is earned within their own Indian country and they meet the criteria identified below, it is recommended that they file returns in order to avoid possible contact by the Department based upon state and federal match programs. A return is required from tribal members if any of the Michigan income is earned outside of their Indian country and/or if any of the criteria below is not met.

Income can be deducted on the Michigan return if **all** the following conditions exist:

1. Individual is a member of a federally recognized Indian Tribe or Band
2. Individual resides within his/her own Tribe or Band's Indian country
3. Activity creating the income in question occurs within the member's Tribe's Indian country
4. Individual attaches a signed "Certification for Exempt Income by Indian Tribal Member" with the return (to be supplied by the Department).

Note: The Department may require documentation to support the above assertions.

The following income is subject to Michigan income tax:

1. Tribal member income earned outside of member's own Tribe's Indian country (including income earned within another Tribe's Indian country).
2. Income earned by a non-member within a Michigan Tribe's Indian country.

Where the Resident Tribal Member's Tribe Has an Implemented Agreement With the State of Michigan

Refer to the terms of the agreement posted on the Michigan Department of Treasury Web site for details on Resident Tribal Member treatment where the member's Tribe has entered into a tax agreement with the State of Michigan. See Treasury's Web site at www.michigan.gov/treasury. Click on *Individual* or *Business* on the left side of the screen, then click on *Native American*. If the Tribe has an implemented agreement it will be posted at this location. If the Tribe is not listed, there is no implemented agreement for that Tribe or its members.

Estimated Income Tax

Forms

Personalized 2005 MI-1040ES forms will be mailed to taxpayers (usually in late January or early February) who paid 2004 quarterly individual income tax estimates. Practitioners should use their clients' personalized forms whenever possible. The personalized forms help ensure that the correct account is credited. **Never photocopy** someone else's personalized forms. Personalized forms are coded with taxpayers' social security number and are optically scanned. Coded information is machine readable on photocopies and through correction tape and fluid.

Requirements for Filing and Paying

Section 301(1) of the Income Tax Act of 1967 states:

“Every person on a calendar year basis, if the person's annual tax can reasonably be expected to exceed the amount withheld under section 351 and the credits allowed under this act by more than \$500.00, shall pay to the department installments of estimated tax under this act on or before April 15, June 15, and September 15 of the person's tax year and January 15 in the following year. Subject to subsection (3), each installment shall be equal to 3 of the taxpayer's estimated tax under this act after first deducting the amount estimated to be withheld under section 351.”

Interest is due for each quarter if no payment or an underpayment exists. Taxpayers who have previously filed estimated tax payments, or form MI-2210, or were assessed in a prior year for underpayment or failure to file estimates, will be assessed penalty as follows:

- 10% penalty for underpayment, or
- 25% penalty for failure to file estimated tax payments.

Failure to Make Estimated Payments

Use form MI-2210 to compute the penalty and interest on the underpayment and file with the 2004 return. If estimated payments are due and have not been paid or are underpaid, the Department will assess penalty and interest not paid by the taxpayer. The assessment will bill for interest on the amount of tax that was due for **each quarter**. An individual may avoid all or part of the penalty and interest if any of the following apply:

1. An individual was not required to file a tax return for 2003.
2. The individual was required to file a return for 2003 but had no tax liability.
3. The amount of tax withheld plus estimated tax payments equal 90% of the tax due for 2004 or 100% of the tax due for 2003 (110% of total 2003 tax if 2004 AGI is more than \$150,000 for married, filing jointly or single filers and \$75,000 for married, filing separately).

4. If income is not received evenly during the year, an individual may annualize his or her income to determine the quarterly estimated payments. *(See 2004 form MI-2210 UNDERPAYMENT OF ESTIMATED INCOME TAX for instructions.)*

Annual Estimated Tax Returns

An individual may file an annual return of estimated tax rather than quarterly returns. To use this option, the taxpayer must file the 2005 first quarter MI-1040ES and pay the total estimated annual tax by April 15, 2005.

Overpayments Credited Forward to Year 2005

The Department will reduce a claimed credit forward to the next year if the return is adjusted. The individual will be notified of the adjustment and the reduction of the credit forward. It is the individual's responsibility to make up any deficiency that may result.

Seafarers, Farmers and Commercial Fishermen

A seafarer, farmer or commercial fisherman who receives at least two-thirds of his/her gross income from seafaring, farming or fishing may file a Michigan annual return of estimated tax no later than January 15, and remit the entire amount of estimated tax with the return. This payment date may be ignored if the seafarer, farmer or fisherman files his/her income tax return and pays the entire amount of tax due by March 1.

If a joint return is filed, the seafarer, farmer, or fisherman must also consider his/her spouse's gross income in determining if at least two-thirds of gross income is from seafaring, farming or fishing.

Wages earned and other income received by seafarers domiciled in Michigan and sailing the Great Lakes or other waterways are subject to the Michigan income tax as provided for in MCL 206.110(1). As such, seafarers must file an annual Michigan income tax return. 46 USCS 11108 precludes the states from withholding state income tax on seafarers' wages; however, this section does not prohibit states from subjecting seafarers' wages to state income tax.

EXEMPTIONS

The number of exemptions that may be claimed is the number of allowable federal personal and dependency exemptions plus Michigan special exemptions.

The following chart illustrates the Michigan exemption allowance.

<u>Tax Year</u>	<u>Based on Federal Exemptions</u>	<u>Michigan Special Exemptions</u>
2000	\$2,900	\$1,800
2001	2,900	1,900
2002	3,000	1,900
2003	3,100	1,900
2004	3,100	2,000

Definitions of Michigan Special Exemptions

Age 65

An individual has attained the age of 65 or older on or before December 31 of the tax year.
[Reference: MCL 206.30(3)(c)]

Deaf

An individual whose hearing is totally impaired or whose hearing, with or without amplification, is so seriously impaired that the primary means of receiving spoken language is through other sensory input, including but not limited to lip reading, sign language, finger spelling, or reading.
[Reference: MCL 206.30(3)(b) and 393.502]

Paraplegic

An individual who has paralysis of the lower half of the body. [Reference: MCL 206.30(3)(a)]

Quadriplegic

An individual who has paralysis of both arms and legs. [Reference: MCL 206.30(3)(a)]

Hemiplegic

An individual who has paralysis of one side of his/her body. [Reference: MCL 206.30(3)(a)]

Blind

An individual who has a permanent impairment of both eyes of the following status: central visual acuity of 20/200 or less in the better eye with corrective glasses, or central visual acuity of more than 20/200 if there is a field defect in which the peripheral field has contracted to such an extent that the widest diameter of visual field subtends an angular distance of not greater than 20 degrees in the better eye. [Reference: 206.30(3)(a) and 206.504(1)]

Totally and Permanently Disabled

An individual who is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than 12 months.

Support for this exemption is the receipt of any of the following types of income:

- Social Security Disability benefits
- Supplemental Security Income (SSI) disability benefits
- Veterans' Administration disability retirement payments.

A taxpayer who does not receive any of the above income may be required to furnish a physician's statement to certify total and permanent disability. *[Reference MCL 206.30(3)(a), 206.522(4) and 42 U.S.C. 416]*

A taxpayer may not claim an exemption for totally and permanently disabled if age 65 or older.

Unemployment Compensation

Return includes unemployment compensation of 50% or more of adjusted gross income (AGI). Only one additional exemption per tax return may be claimed under this category. *[Reference: MCL 206.30(3)(d)]*

Example 1: Tony is 66, but before he turned age 65 he received Social Security Disability for being totally and permanently disabled. Assuming Tony is not deaf, blind, or para/quadri/hemiplegic, and received no unemployment compensation during 2004, Tony's exemption allowance would be computed as follows:

Federal Exemption (one x \$3,100)	\$3,100
Michigan Special Exemptions (one x \$ \$2,000)	<u>2,000</u>
Total Exemption Allowance	\$5, 100

Note: Although Tony's condition did not change when he reached the age of 65, he may no longer claim an exemption for being totally and permanently disabled.

Example 2: Bonney is 67 and is deaf and blind. She received Social Security Disability until the age of 65. Bonney's exemption allowance for 2004, assuming she received no unemployment compensation, would be computed as follows:

Federal Exemption (one x \$3,100)	\$3,100
Michigan Special Exemptions (two x \$ \$2,000) (one for age, and one for blind or deaf)	<u>4,000</u>
Total Exemption Allowance	\$7,100

Part-Year and Nonresident

The exemption allowance for a part-year resident or a nonresident is prorated based on the taxpayer's Michigan AGI sources divided by total AGI.

For a couple filing a joint return, if one spouse is a full-year resident and the other is a part-year resident or nonresident, the full-year resident is entitled to one full \$3,100 exemption. The part-year resident or nonresident must prorate the \$3,100 exemption in the ratio of his or her AGI from Michigan sources to his or her AGI from all sources. Exemptions for dependents must be prorated in the ratio of combined (both spouses') AGI from Michigan sources to combined AGI from all sources.

Example: Sam and Sara were married June 30, 2004. Sara has two dependent children under 19. Sara worked and lived in Florida prior to their marriage. She continued to work after moving to Michigan in June 2004. Her interest was received equally throughout the year. Sam was a Michigan resident all of 2004. Their income was as follows:

	<u>Sam</u>	<u>Sara</u>
Wages	\$55,500	\$25,000
Interest	<u>2,500</u>	<u>5,000</u>
Total AGI	\$58,000	\$30,000

The exemption allowance is computed as follows:

Sam was a Michigan resident all year and is entitled to a \$3,100 exemption allowance.

Sara earned wages of \$15,000 in Florida, and 50% of her interest income is allocated to Florida.

$$\begin{array}{rcl} \text{Michigan income} & \underline{\$12,500} & \\ \text{(divided by) total income} & \$30,000 & = 42\% \end{array}$$

$$42\% \text{ Michigan source income} \times \$3,100 = \$1,302$$

Dependents - Combined Michigan source to all source

$$\begin{array}{rcl} \text{Combined Michigan income} & \underline{\$70,500} & \\ \text{(divided by) combined total income} & \$88,000 & = 80\% \end{array}$$

$$80\% \text{ Michigan source income} \times \$6,200 = \$4,960$$

Total exemption allowance for 2004 joint Michigan income tax return is:

Sam	\$3,100
Sara	1,302
Dependents	<u>4,960</u>
Total	\$9,362

Claimed as a Dependent

An individual cannot claim a personal exemption if another taxpayer (usually a parent) can claim a dependency exemption for that person. This is true even when the individual is not actually claimed as a dependent on the other's return. However, an individual who is eligible to be claimed as a dependent on someone else's return and has an adjusted gross income of **\$1,500 or less** is entitled to a **refund** of all Michigan tax withheld. An individual who is eligible to be claimed as a dependent on someone else's return and has an adjusted gross income of **more than \$1,500** is entitled to a \$1,500 deduction.

A dependent who may not claim a personal exemption may still claim one or more of the special exemptions.

Example 1: Darin (age 16 and can be claimed as an exemption on his parents' return) earned \$6,050 during 2004. He is considered deaf as defined in MCL 206.30(3)(b) and 393.502. His adjusted gross income (AGI) is \$6,050 and his Michigan income tax withholding is \$153. Darin's Michigan income tax liability is computed as follows:

AGI	\$6,050
Less: Deduction	(1,500)
Michigan Special Exemption	<u>(2,000)</u>
Taxable Income	2,550
x Tax Rate	<u>x .0395</u>
Michigan Income Tax (Rounded)	\$ 101
Michigan Income Tax Withheld	153
Less: Michigan Income Tax	<u>(101)</u>
Refund	\$ 52

Example 2: Cheri is 17 and can be claimed as a dependent by her parents. Cheri's adjusted gross income for 2004 is \$1,450 and her Michigan income tax withholding is \$70. Cheri's Michigan income tax liability is computed as follows:

AGI	\$1,450
Less: Deduction	<u>(1,500)</u>
Taxable Income	-0-
Michigan Income Tax	-0-
Michigan Income Tax Withheld	<u>70</u>
Refund	\$ 70

CHILD CARE DEDUCTION

The child care deduction is \$600 for each dependent claimed on the federal return who is 18 years old or younger on the last day of the tax year.

Example: Bob and Karen reported 6 exemptions on their 2004 federal return. The exemptions were for Bob, Karen, and for their children Emma, Ann, Dusty, and Jim who are 6, 7, 16, and 19 years old .

The personal exemption allowance Bob and Karen report on their 2004 MI-1040 is \$18,600 (\$3,100 x 6). They also report an additional deduction of \$1,800 calculated as follows:

Emma (6 years old)	\$ 600
Ann (7 years old)	600
Dusty (16 years old)	<u>600</u>
Total additional deduction	\$1,800

MICHIGAN INCOME TAX TREATMENT OF CHILD'S UNEARNED INCOME

Section 1(g)7 of the IRS Code provides for an election that allows parents to include unearned income of a child on the parents' return when: (1) the child is under 14 years old, (2) has no income other than interest and or dividends, (3) gross income is less than \$7,000, and (4) no estimated payment or withholding has been made on behalf of the child.

If the parents take the Section 1(g)7 election, the amount of the child's unearned income in the parents' AGI is subject to Michigan income tax. The amount must also be included in household income when computing the property tax, farmland and home heating credits.

ADJUSTMENTS TO ARRIVE AT MICHIGAN TAXABLE INCOME

The following is a list of common additions and subtractions made on the Michigan income tax return.

Additions

Interest and dividend income from non-Michigan municipal obligations. (Add this income even if it comes through a fund, partnership, S corporation, estate or trust.)

Capital gain adjustments (from Michigan column of MI-1040D or MI-4797)

Losses from a business or property located in another state

Losses from the disposal of U.S. obligations to the extent used in arriving at adjusted gross income

Taxes on or measured by income, e.g., deduction for self employment tax

Amount not included in AGI that was an unqualified withdrawal from education savings accounts as provided in the Michigan Education Savings Program Act

Amount of net operating loss deduction (NOL carryforward) used to reduce AGI

Refund received from a Michigan Education Trust (MET) contract.

Subtractions

Income from U.S. government obligations reduced by any expenses in carrying the obligation used in arriving at adjusted gross income

Income from a business or property located in another state

Compensation and retirement benefits received for services in the U.S. Armed Forces. (Do not deduct compensation received from the U.S. Public Health Service.)

Capital gain adjustments (from federal column of MI-1040D or MI-4797)

Retirement and pension benefits (*see MCL 206.30(1)(f)*)

Dividend/interest/capital gains deduction for senior citizens

Michigan State and local income tax refunds to the extent included in AGI

Property tax credit to the extent included in AGI

Contributions to national or Michigan political parties (limit \$50 single, \$100 joint return)

Proceeds and prizes won in State of Michigan regulated bingo, raffle or charity game to the extent included in AGI

The amount of salary and wage expense that cannot be deducted on the federal return under Section 280C of the Internal Revenue Code

Social security benefits to the extent included in AGI

Income earned while a resident of a Renaissance Zone

Amount used to determine credit for the elderly or totally and permanently disabled from U.S. Schedule R or U.S. 1040A, Schedule 3

Tier 1 is taxable as social security on the federal return and should be subtracted as social security benefits to the extent in AGI.

Contributions made after October 1, 2000 to the MESP, not to exceed \$5,000 for a single return or \$10,000 for a joint return per year.

The amount of an advance payment under a MET contract during the tax year.

Items Not Allowed as Subtractions

Itemized deductions from federal Schedule A

Unemployment benefits included in AGI

Sick pay, disability benefits and wage continuation benefits paid to a taxpayer by his or her employer or by an insurance company under contract with the employer

Distributions from deferred compensation

Lottery winnings won on January 1, 1989 or later.

MISCELLANEOUS DEDUCTIONS

Income From Oil and Gas Production

The Michigan income tax treatment of revenue from oil and gas production was addressed by the Michigan Court of Appeals in separate cases, *Cook v Department of Treasury* and *Miller v Department of Treasury*, 229 Mich App 653, and *Elenbaas v Department of Treasury*, 235 Mich App 372; 597 NW 2d (1999).

Both cases involved the Michigan income tax treatment of revenue from oil and gas production that is subject to the Michigan Severance Tax. The Michigan Severance Tax is a specific tax levied upon each producer extracting or severing oil and gas from the soil in Michigan. This tax is based upon a percentage of the gross cash market value of the product as computed at the wellhead.

In previous cases, the Michigan Court of Appeals ruled in 1993 that the Michigan severance tax was paid in lieu of all other state and local taxes and exempted oil and gas royalties from the Michigan income tax. These cases did not address the income tax treatment accorded expenses incurred by producers engaged in the production of the tax exempt income. The Department issued Revenue Administrative Bulletin 1996-1 to take the position that the **net** production income could be subtracted on the Michigan income tax return.

On July 20, 1999, the Michigan Court of Appeals issued a final published decision of a special conflict resolution panel in *Elenbaas v Department of Treasury*. The ruling held that taxpayers could calculate Michigan taxable income by excluding gross income from oil and gas activities subject to severance taxes while still deducting related expenses.

In the consolidated cases of *Cook v Department of Treasury* and *Miller v Department of Treasury*, the Michigan Court of Appeals held that taxpayers must exclude exempt oil and gas income and related expenses in calculating the NOL deduction allowed by the Michigan Income Tax Act.

The Michigan Supreme Court denied leave to appeal on all issues in the above cases on December 7, 2000. The effect of this denial leaves the final published Court of Appeals decisions as binding.

Charitable Distribution Subtraction

A taxpayer may deduct from taxable income, to the extent included in federal adjusted gross income, assets received as qualified distributions from a retirement or pension plan made to a qualified charitable organization during the tax year.

This deduction is equal to the allowable amount under 170(c) of the IRC and is reduced by any pension subtraction taken and by two times the total amount of credits claimed under MCL 206.260 and 261. These credits include Public Contribution Credit, Homeless Shelter/Food Bank Credit and the Community Foundation Credit.

A “qualified charitable deduction” is a distribution of assets to a qualified charitable organization exempt under IRC Section 501(c)(3) by a taxpayer within 60 days after the date the taxpayer received the assets as a distribution from a retirement or pension plan that qualifies under MCL 206.30(8)(a).

A “qualified charitable organization” is:

1. An organization under IRC Section 501(c)(3) **except** an organization that is controlled by a political party, an elected official or a candidate for an elective office.

2. A charitable remainder annuity trust or a charitable remainder unitrust under IRC Section 664(d).
3. A pooled income fund under IRC Section 642(c)(5).
4. Issuance of a charitable gift annuity under IRC Section 501(m)(5).

A trust, fund, or annuity described above is a qualified charitable organization **only** if no person holds any interest in the trust, fund, or annuity other than one or more of the following:

1. The taxpayer who received the distribution from the retirement or pension plan.
2. The spouse of the taxpayer.
3. An organization described in IRC Section 501(c)(3).

RENAISSANCE ZONES

The Michigan Renaissance Zone Act, Public Act (PA) 376 of 1996, permitted the designation of specific regions in Michigan as Renaissance Zones. The Michigan Economic Development Corporation (MEDC) administers the Renaissance Zone program and conducts the zone selection process.

Generally, an individual living in or a business located and conducting business activities in a Renaissance Zone will receive an exemption, deduction, or credit from the following state and local taxes:

- | | |
|--------------|---|
| Individuals: | Michigan Income Tax
Property Tax (except debt mills)
City Income Tax (if applicable)
Utility Users Tax (Detroit only) |
| Businesses: | Property Tax (except debt mills)
Portion of Michigan Single Business Tax and City Income Tax
attributable to business activity in the zone. |

However, no deduction or credit will be allowed if the taxpayer is delinquent in any taxes covered in the Renaissance Zone Act.

IMPORTANT: A designated zone may be located within the boundaries of a city or county, but there are no established zones that include an *entire* city or county. Contact the local authority to determine if you or your client lives within the boundaries of a zone.

Residents of a Renaissance Zone are eligible for a deduction on the Michigan income tax return after meeting the Zone residency requirement of at least 183 consecutive days. Persons whose gross income exceeds \$1 million for the tax year are **not** eligible for the deduction. The taxpayer can deduct most income earned and received while a resident of the Zone. Form MI-1040 MICHIGAN INCOME TAX RETURN must be filed to claim the deduction. Once an individual has completed the 183-day residency requirement in a Zone, that individual should file a revised form MI-W4 EMPLOYEE'S MICHIGAN WITHHOLDING EXEMPTION CERTIFICATE to claim exemption from Michigan income tax withholding. The employer should stop Michigan income tax withholding upon receipt of a revised MI-W4 and must forward a copy of the MI-W4 to the Michigan Department of Treasury.

For information regarding the specific zones, visit the MEDC Web site at <http://medc.michigan.org/services/sitedevelopment/renzone/#>. If you have tax questions relating to the zones, contact the Michigan Department of Treasury at (517) 636-4280.

PENSION AND RETIREMENT BENEFITS

A subtraction is allowed on the Michigan return for qualifying distributions from retirement plans. Retirement plans include private and public employer plans, and individual plans, such as IRA's. To be considered a qualified distribution for the subtraction, several requirements must be met. For employer plans, an employee generally must have retired under the provisions of the plan, the pension benefits must be paid from a retirement trust fund, and the payment must be made to either the employee or a surviving spouse. (Payments made to a surviving spouse are only deductible if the employee qualified for the subtraction at the time of death.)

Public Pensions

Public pensions are retirement or pension benefits received from a federal or Michigan public retirement system, or from a retirement system of a political subdivision of Michigan. Distributions from these retirement systems may be deducted to the extent included in AGI.

Private Pensions

Private pensions are retirement or pension benefits distributed from a pension trust qualified under section 401(a) of the Internal Revenue Code. The maximum deduction for a private pension is adjusted annually by the percentage increase in the U.S. Consumer Price Index. The maximum deduction for the 2004 tax year is \$38,550 on a single return and \$77,100 for a joint return.

The following table outlines the current year's and prior years' maximum pension deductions.

<u>Tax Year</u>	<u>Single Return</u>	<u>Joint Return</u>
2000	\$34,920	\$69,840
2001	36,090	72,180
2002	37,110	74,220
2003	37,710	75,420
2004	38,550	77,100

Example: Steve is retired and single. He has a State of Michigan pension of \$33,450 and a qualified private pension of \$13,030. His total pension deduction for 2004 is determined as follows:

Maximum Private Pension Deduction	\$38,550
Less: Public Pension	<u>-33,450</u>
Allowable Private Pension Subtraction	\$ 5,100
Steve's total pension subtraction is:	
Public	\$33,450
Private	<u>5,100</u>
Total	\$38,550

If Steve's State pension was \$40,000, then he would be limited to a maximum deduction of \$40,000.

Examples of other distributions that qualify for the private pension deduction are:

- **IRA.** Distributions for individuals 59½ or older, distributions made on account of disability or death of the participant, and distributions described under Internal Revenue Code section 72(t)(2)(iii)(iv) (Series of equal periodic payments made for life). Distributions made on account of the death of the participant may only be subtracted by a surviving spouse, and only if the distributions qualified as a subtraction for the participant at the time of death.
- **Senior Citizen Annuity.** Benefits received from a retirement annuity policy in which payments are made for life to a senior citizen.

For purposes of the retirement annuity subtraction, a senior citizen is defined in MCL 206.514(1) as an "individual . . . who is 65 years of age or older at the close of the tax year. The term also includes the unremarried surviving spouse of a person who was 65 years of age or older at the time of death."

- **401(k) or 403(b) Deduction.** Distributions from a 401(k) or 403(b) plan are deductible to the extent that they represent distributions attributable to the employer's contributions or employee's contributions that were mandated by the plan. An employee's contribution required by the plan to elicit an employer match is considered to be mandated, and a distribution of such amounts may be subtracted as a retirement benefit on the Michigan income tax return. Amounts received from a 401(k) or 403(b) plan that allows the employee to set the amount of compensation to be deferred and does not prescribe retirement age or years of service do not qualify as retirement and pension benefits.

Example: Terry's employer established a 401(k) plan for its employees. The plan provides for a 50% employer match of employee contributions up to the maximum employer match of 3% of the employee's salary. The plan also allows the employees to make additional unmatched contributions up to the annual percentage rate allowed by the Internal Revenue Code. In 2004, Terry retired under the provisions of the retirement plan at age 60. At the time of his retirement, Terry received an annual statement from the 401(k) plan showing total contributions of \$450,000, of which \$100,000 were employer contributions. Terry took a distribution of \$24,000 in 2004, the year he retired.

Since the plan includes unmatched employee contributions, Terry must determine what amount of the \$24,000 distribution is attributed to the unmatched contributions. The plan called for a 50% employer match; therefore, \$200,000 of the employee contributions was required to elicit \$100,000 employer matching contributions. The remaining account balance of \$150,000 is unmatched employee contributions. The deductible amount of the 2004 distribution is determined as follows:

$$\$150,000/\$450,000 \times \$24,000 = \$8,000 \text{ (distribution attributed to unmatched distribution)}$$

$$\$24,000 - \$8,000 = \$16,000 \text{ (allowable pension subtraction)}$$

Note: All pension income **must** be included in household income except that which is derived from **original contributions** made by the taxpayer to the pension fund.

An individual having a pension from both a public and a private retirement system or an IRA distribution must reduce the maximum allowable subtraction for the private pension by any distribution taken for pension income from a public retirement system.

Roth IRAs

Contributions to a Roth IRA are subject to Michigan income tax to the extent the contributions included in federal adjusted gross income (AGI).

A rollover from a regular IRA to a Roth IRA is subject to Michigan income tax to the extent the rollover is included in federal AGI. However, if an individual is 59 ½ when the rollover occurs, the individual may deduct the rollover as a pension deduction within the statutory limits for deducting pension income.

Also, a rollover from a regular IRA to a Roth IRA is subject to Michigan income tax for a taxpayer moving into and domiciled in Michigan to the extent the rollover is included in AGI. Conversely, a taxpayer moving from Michigan to another state is not taxed on the amount of a rollover from a regular IRA to a Roth IRA during the years the taxpayer is not domiciled in Michigan.

A qualified distribution from a Roth IRA is not subject to Michigan income tax because the distribution is not included in federal AGI.

A rollover from a regular IRA to a Roth IRA is included in household income in the year the income is included in the taxpayer's federal AGI. 2003 was the first year a qualified or tax free distribution may be made from a Roth IRA. The amount of a qualified distribution in excess of a taxpayer's contributions (rollover or regular contributions) must be included in household income. A nonqualified or taxable distribution from a Roth IRA must be included in household income to the extent it is included in a taxpayer's federal AGI. Investment losses from the liquidation of a Roth IRA are not allowed in household income.

Railroad Retirement and Pension Benefits

The taxable amount of Tier 2 income included in AGI may be subtracted as a public pension on the Michigan return. (Tier 1 is taxable as social security on the federal return and should be subtracted as social security benefits to the extent in AGI.)

Public Retirement Pensions From Other States

For individuals who receive public retirement benefits from another state, the following limitations for the deduction of public retirement and pension benefits apply.

To the extent included in AGI, this subtraction is limited to the greater of:

\$38,550 for a single return (\$77,100 for a joint return) for 2004 tax year

OR

Amount allowed as a deduction or exemption by the other state to its residents on public retirement pensions received from Michigan.

The following states allow a deduction or exemption for their residents who receive Michigan public pensions to the extent included in adjusted gross income. Therefore, Michigan will allow a deduction for the full amount included in adjusted gross income on the Michigan return for **public** pensions received by Michigan residents from the following states:

Alaska	New Hampshire
Florida	Pennsylvania
Hawaii	South Dakota
Illinois	Tennessee
Massachusetts	Texas
Mississippi	Washington
Nevada	Wyoming

2004 Pension and Retirement Subtraction Table

The 2004 deductible retirement and pension benefits are limited to the lesser of the amount included in AGI or the amounts shown below.

<u>Source of Retirement Benefits</u>	<u>Single</u>	<u>Joint</u>
U.S. Civil Service	Amount included in AGI	Amount included in AGI
State of Michigan	Amount included in AGI	Amount included in AGI
Michigan political subdivisions	Amount included in AGI	Amount included in AGI
Private	\$38,550	\$77,100
Public pensions (from other states)	\$38,550 or reciprocal limit whichever is greater	\$77,100 or reciprocal limit whichever is greater
Qualified senior citizen retirement annuities	\$38,550	\$77,100

Source of Retirement Benefits	<u>Single</u>	<u>Joint</u>
Public and private	Limited to public pension or \$38,550 whichever is greater	Limited to public pension or \$77,100 whichever is greater

The following distributions cannot be deducted as pension benefits:

1. Deferred compensation plans that allow the employee to set the amount of compensation to be deferred and do not prescribe retirement age or years of service
2. Commercial Annuity Policies (unless the payments are made for life to a senior citizen)
3. Premature separation, withdrawal or discontinuance of a plan prior to the earliest date the recipient could have retired under the provisions of the plan
4. Payments received as an incentive to retire early unless the distributions are from a pension trust
5. Eligible distributions received by a relation of the deceased except the surviving spouse.

DEFERRED COMPENSATION

Distributions received from deferred compensation plans which allow the employee to set the amount of compensation to be deferred and do not prescribe retirement age or years of service are treated as ordinary income. Deferred compensation distributions are usually **not** considered pension income and may **not** be subtracted on the Michigan return.

Federal law, Title 4, Chapter 4, Section 114, prohibits a state from taxing certain deferred compensation distributions received by a nonresident after December 31, 1995. Therefore, nonresidents will no longer be subject to Michigan income tax on distributions from deferred compensation plans as defined in Internal Revenue Code (IRC) sections 401(k), 457, and 3121(v) (2)(c) for payments received after December 31, 1995.

SENIOR CITIZEN INTEREST, DIVIDENDS, AND CAPITAL GAINS DEDUCTION

Senior citizens may take a deduction for interest, dividends, and capital gains up to \$8,595 for a single return and \$17,190 for a joint return for the 2004 tax year. The deduction will be adjusted by the percent increase in the U.S. Consumer Price Index for future years. This maximum deduction must be reduced by the amount of deduction taken for pension and retirement income.

The term “senior citizen” refers to a person 65 years of age or older or an unremarried surviving spouse of an individual who was 65 years of age or older at the time of death.

Example: Step 1: Harold and Lucy are retired senior citizens and file a joint income tax return. A partial listing of their income is as follows:

Pension Income	\$ 4,000
Capital Gains	11,000
Dividend Income	800
Interest Income	2,600

Step 2: Calculation of interest, dividend and capital gains deduction:

Maximum Deduction	\$17,190
Less: Pension Subtraction	<u>4,000</u>
Maximum Allowable Deduction	\$13,190

Step 3: Total interest, dividends and capital gains = \$14,400

Step 4: Use the lesser of the total interest, dividends and capital gains (\$14,400) or the maximum allowable deduction (\$13,190).

Step 5: The interest, dividends and capital gains deduction for Harold and Lucy is **\$13,190.**

EDUCATION PLANS

Michigan Education Savings Program

The Michigan Education Savings Program (MESP) is administered by Treasury and managed by TIAA-CREF. To open an education savings account, an individual must enter into an agreement with the program manager. The maximum account balance limit to any one beneficiary account cannot exceed \$235,000.

Distributions from the account must be used to pay qualified higher education expenses incurred after the account is established. A nonqualified distribution will be subject to a penalty of 10% of the distribution if no federal penalty is imposed on the nonqualified withdrawal.

A deduction may be taken on the Michigan income tax return for contributions made to the MESP on and after October 1, 2000. The maximum deduction is \$5,000 for a single filer (\$10,000 for a jointly filed return). A deduction is not allowed for contributions to an education savings account if a withdrawal has been made from the account in the current year. A taxpayer must add to federal adjusted gross income (AGI) any nonqualified withdrawal from the MESP in the year of the withdrawal.

Interest earned on contributions made to an MESP account may be deducted to extent included in AGI. The beneficiary of the MESP account may deduct qualified withdrawals to the extent included in AGI.

For more information or for enrollment materials on the MESP, contact 1-877-861-MESP or www.misaves.com.

Michigan Education Trust

The Michigan Education Trust (MET) allows parents, grandparents and others to prepurchase undergraduate in-state and in-district tuition for a child at any Michigan public college, university, junior or community college.

Payments made under an advance payment contract in a MET during the tax year are deductible to the extent they are included in federal AGI on a purchaser's Michigan income tax return. The \$25 application fee may also be subtracted on the Michigan return. Interest payments made on loans to finance the contract are not deductible. MET contracts are only set up in specified enrollment periods.

Beginning with the 2002 year, earnings on the qualified distributions are tax-free on the beneficiary's federal and state income tax returns. A nonqualified distribution is subject to federal and state income tax.

For more information or contract materials on MET, contact 1-800-MET-4-KID or at treasMET@michigan.gov.

Educational IRA

The Educational IRA is structured as trusts or custodial accounts for the purpose of paying educational expenses of a designated beneficiary and follows the same general rules as other IRAs.

The contributions made to this trust or custodial account are not tax deductible. Beginning January 1, 2002, the contributions are limited to \$2,000 a year.

The distributions from an Educational IRA are tax-free if they do not exceed the beneficiary's qualified educational expenses to an approved educational institution. An approved institution is any accredited postsecondary educational institution offering credit towards an associates, bachelors, graduate level or professional degree.

Any investment earnings will accrue tax-deferred or tax-free.

NONRESIDENTS' TAXABLE INCOME

The following income of nonresidents is subject to the Michigan income tax:

1. Salary, wages, commissions and other personal service income for work performed in Michigan
2. Income, including portfolio income, from partnerships, S corporations, and other flow through entities having business activity in Michigan, or business or farm income from a sole proprietorship or farm located in Michigan
3. Rent and royalty income from real and tangible personal property located in Michigan
4. Capital gains/losses from the sale or exchange of real or tangible personal property located in Michigan
5. Patent or copyright royalties if the patent or copyright is used in Michigan or has a commercial domicile in Michigan
6. Michigan lottery winnings
7. Casino winnings and winnings from pari-mutuel wagering at a licensed horse racing meetings.

Michigan has reciprocal agreements with Illinois, Indiana, Kentucky, Minnesota, Ohio and Wisconsin that exempt nonresidents from income taxes imposed by each state on salaries, wages and other employee compensation. Business income is not subject to these reciprocal agreements; this income is subject to the apportionment provisions of the Michigan Income Tax Act.

Revenue Administrative Bulletin 2003-4
Approved December 8, 2003

This Bulletin describes the income tax withholding and reporting requirements of flow-through entities with nonresident members and activity in Michigan. In addition, it explains the term “flow-through entities,” “income available for distribution,” “tiered entities,” and clarifies the withholding requirements of flow-through entities electing to file composite income tax returns on behalf of nonresident members. This Bulletin and these definitions have no application to the Michigan Single Business Tax. Finally, this Bulletin explains specific exemptions from the flow-through entity withholding requirements of the Michigan Income Tax Act.

**S CORPORATION, PARTNERSHIP OR FLOW-THROUGH ENTITY
DISTRIBUTION OF INCOME AND LOSSES**

Income flowing through to a shareholder of an S corporation, a partner of a partnership, or a member of any other flow-through entity is business income and is subject to the allocation and apportionment provisions of the Michigan Income Tax Act. The taxpayer’s distributive share of such income and losses shall be allocated and apportioned to the state where the business activity takes place using the apportionment factor of the business entity.

Income allocated or apportioned to Michigan is taxable to Michigan. Income not allocated or apportioned to Michigan may be claimed as a subtraction from adjusted gross income. Conversely, losses not allocated or apportioned to Michigan must be added to adjusted gross income.

Portfolio income is considered to be business income and is subject to allocation or apportionment. Portfolio income includes: interest income, dividend income, royalty income, and net short-term and long-term capital gain (loss) from Federal Schedule D. Resident or nonresident individual taxpayers having portfolio income from a multistate partnership, S corporation, or other flow-through entity must apportion this income based upon the business entity’s apportionment factor.

A nonresident partner of a Michigan partnership, a nonresident shareholder of a Michigan S corporation or a member of a Michigan flow-through entity must file a Michigan return to report his or her distributive income from the corporation/partnership/flow-through entity.

When filing form MI-1040H SCHEDULE OF APPORTIONMENT it should be noted that the computation of the property and sales factors may not be the same for individual income tax and single business tax. For income tax purposes, property must be owned and used. When computing the sales factor, throwback sales for income tax follow PL 86-272 standards. Also, foreign sales can be in the numerator for income tax purposes. The income tax standard for determining if the taxpayer is taxable in another state uses the PL 86-272 nexus criteria. In general, a taxpayer’s business must have property in another state or activity that goes beyond solicitation of sales in order to be taxable in the other state.

An S corporation is permitted to own a qualified subchapter S subsidiary (QSSS). The term includes any domestic corporation that qualifies as an S corporation and is 100-percent owned by an S corporation parent, which elects to treat it as a QSSS. The assets, liabilities, and items of income, deduction and credit of the QSub as treated as those of the parent S corporation.

Composite Individual Income Tax Return **for Nonresident Partners/Shareholders/Members**

The Department will enter into agreements with partnerships, S corporations, and other flow-through entities to allow the filing of a composite return for nonresident partners/shareholders/members. The firm must have two or more nonresident partners/shareholders/members who participate on the composite return.

Questions and requests for agreements should be addressed to:

*Return Processing Division
Michigan Department of Treasury
Lansing, MI 48922*

MI-1040D - ADJUSTMENTS OF CAPITAL GAINS AND LOSSES

The purpose of this form is to exclude from Michigan taxable income gains and losses that should not be taxed by Michigan. Michigan has had an Income Tax Act since October 1, 1967. If a taxpayer sells property that he or she owned prior to that date, only that portion of the gain attributable to the time Michigan has had an income tax can be taxed. Similarly, if the gain was attributable to another state and therefore not subject to Michigan tax, it cannot be included in Michigan taxable income. This form adds in the Michigan gain and subtracts out the federal gain so the taxpayer is only taxed on the Michigan portion. If the form computes to a loss, the federal loss is added back in the same manner as an out-of-state loss and the Michigan loss is subtracted.

Beginning with tax year 2003, taxpayers filing form MI-1040D may file electronically.

An MI-1040D for the adjustment of **capital gains and losses** must be used if any of the following are true:

1. Taxpayer disposes of assets acquired prior to October 1, 1967, and elects to exclude gains or losses under section 271.

To apportion under Section 271:

Multiply gain or loss by months property was held after September 30, 1967. Then divide the result by the total number of months held.

2. Taxpayer has gains or losses from the sale or exchange of U.S. obligations that cannot be taxed by Michigan.

3. Taxpayer has gains or losses from property subject to the allocation and apportionment provisions.

Example: Douglas reported the following capital gains on his federal Schedule D:

From sale of stock	\$ 8,500
From sale of real property in Los Angeles, CA	<u>4,000</u>
Total Schedule D capital gain	\$12,500

After preparing form MI-1040D, the \$12,500 total capital gain is reported as a subtraction from AGI on the MI-1040, and the \$8,500 capital gain on the sale of stock is reported as an addition to AGI on the MI-1040. This removes the \$4,000 gain from the sale of real property in Los Angeles from Michigan taxable income.

NET OPERATING LOSS (NOL) CARRYBACK AND CARRYOVER

MCL Section 206.30(1)(o) and (p) were enacted by legislative amendment in 1987 to provide a net operating loss deduction for Michigan income tax purposes. Several recent court *cases* (*Preston v. Department of Treasury*, 190 Mich App 4941, 476 NW 2nd 455 (1991), and *Beznos v. Department of Treasury*, 224 Mich App 717; 569 NW 2d 908 (1997), have clarified the income tax treatment of the Michigan NOL and NOL deduction. In *Preston*, the Michigan Court of Appeals ruled that a taxpayer could have and utilize a Michigan NOL in the absence of a corresponding federal NOL. In *Beznos*, the Court held that the Michigan NOL deduction was **not** limited to the smaller of the federal NOL deduction or federal modified taxable income. In so ruling, the Court stated that the Michigan NOL and NOL deduction must be computed without federal itemized deductions.

As a result, the Department calculates the Michigan NOL and NOL deduction independently of the federal NOL and NOL deduction. The Michigan NOL calculation is computed by applying the NOL provisions of section 172 of the Internal Revenue Code to only income, losses, and deductions allocated and apportioned to Michigan under chapter 3 of the Michigan Income Tax Act. Further, the Michigan NOL is computed without regard to federal itemized deductions in the year of the loss, or income and losses from oil and gas production that is subject to Michigan Severance Tax. The Michigan NOL so computed may then be subtracted in full on the Michigan return in the year to which it is properly carried.

PA 261 of 1988 amended MCL Section 206.510(1) to reinstate the federal NOL deduction as an adjustment to household income. For tax periods commencing after December 31, 1987, the allowed NOL deduction used to reduce household income may not exceed federal modified taxable income, or the federal NOL deduction, whichever is smaller. The inclusion of the allowed NOL deduction in household income may be used to increase the amount of the homestead property tax credit, the home heating credit (an NOL carryback cannot be used on the home heating credit for years after 1995), the farmland preservation tax credit, and the prescription drug credit to which a taxpayer is entitled. (Note: the Appeals Court decision in the *Preston* and *Beznos* cases left intact the Department's handling of the NOL deduction in household income.)

The Tax Reconciliation Act (TRA) of 1997 amended Internal Revenue Code Section 172 to limit the NOL carryback period to 2 years and extended the NOL carryforward period to 20 years for most NOLs. The changes are effective for tax periods commencing after August 5, 1997. Treasury will follow the amendment to the IRC regarding the NOL carryback and carryforward provisions. The changes to the Michigan NOL are effective for the 1998 calendar year. For fiscal year filers, the change will be effective for tax years beginning after August 5, 1997.

Under the Job Creation and Worker Assistance Act of 2002, the general federal NOL period is temporarily extended from 2 years to 5 years for taxable years ending in 2001 and 2002. A taxpayer may elect to forego the 5-year carryback period by making an election in the manner prescribed by the Internal Revenue Service. For Michigan income tax purposes, a 5-year carryback period will be allowed as provided for under the NOL provisions of the Internal Revenue Code. A separate Michigan election may be made to forego the 5-year carryback period independently of any election made at the federal level.

Frequently Asked Questions

1. Q. If a return with a net operating loss is filed after the four-year statute of limitations for claiming a refund has expired, does the taxpayer lose the benefit of the net operating loss?
 - A. The taxpayer cannot file a claim for a refund for any years that are beyond the four-year statute of limitations. (Exception: If the loss year (NOL year) return is filed within four years of the due date, the NOL may be carried back to a year that is otherwise outside of the statute of limitations and a refund will be made.) However, this would not negate the fact that a net operating loss can be carried forward 15 years (20 years for tax periods commencing after August, 1997), and the taxpayer could receive a tax benefit from subsequent years which were in statute. Remember, the taxpayer must utilize the Michigan net operating loss to the extent of Michigan income subject to tax in the "out-of-statute" years to determine the amount that can be carried forward to years that are filed within the four-year statute of limitations.

2. Q. Can a taxpayer create a Michigan NOL if there is no corresponding federal NOL?
 - A. Yes, based on the Appeals Court decision in *Arthur Preston v Michigan Department of Treasury*. Complete form MI-1045 to determine the amount of the Michigan NOL if the taxpayer has no federal NOL. This may occur when a taxpayer has income from other states or income from oil and gas production that is subject to severance tax.

3. Q. What are the implications on a net operating loss carryback/forward when the filing status of an individual changes (e.g., joint to separate or single, etc.)?
 - A.

<u>Year of NOL</u>	<u>Year of Carryback/forward</u>
Joint NOL	Single or separate return filed – determine each individual’s share of the joint net operating loss and apply his/her share to his/her separate or single returns.
Married, Filing Separate	Joint return filed – apply NOL to their joint return.
Single	Joint return filed – separate their income and deductions and apply NOL to the individual sustaining a net operating loss as a single individual.

4. Q. Can a net operating loss carryback/forward be used to reduce household income?
 - A. Yes, to the extent of a taxpayer’s federal modified taxable income for years after 1987. For years before 1988, the entire NOL deduction used to reduce federal adjusted gross income may be used to reduce household income. Remember, the NOL deduction is **not** subject to apportionment for household income purposes.

Tips for Filing

1. Enter allowable net operating loss deduction on line 26 on the property tax form MI-1040CR as other adjustments to income.
2. When listing an NOL deduction, specifically identify the amount. Many times a notation is made, such as miscellaneous deductions, which includes other items (e.g., jury duty, directors’ fees, etc.) that makes it impossible to determine what amount the taxpayer is claiming as an NOL deduction.
3. The main concerns when reviewing a return with an NOL deduction are determining if: (1) the apportionment provisions of the Michigan Income Tax Act have been complied with, and (2) the NOL deduction has been correctly limited to federal modified taxable income in the schedule of household income on the refundable credit claims (e.g., homestead property tax credit).

4. To expedite processing, Treasury currently requests copies of pages 1 and 2 of a taxpayer's federal income tax return and all supporting federal tax schedules when an NOL deduction is claimed for both the year of the loss and the year it is carried to. If the information is not attached, Treasury may write to the taxpayer and request copies of these schedules.
5. A taxpayer may create a federal NOL when adjusted gross income is greater than zero, which will result in a Michigan NOL deduction in the schedule of household income only. Itemized deductions may not be used to create a Michigan NOL deduction for Michigan taxable income purposes.
6. Casualty losses, employee business expenses, moving expenses and other itemized deductions classified as business expenses for federal NOL purposes may create or contribute to a Michigan NOL deduction for household income purposes only. These itemized deductions may no longer contribute to or create a Michigan NOL deduction for Michigan taxable income purposes. When filing a Michigan return with an NOL deduction created in whole or in part by federal itemized deductions, include federal Schedule A and any related schedules (e.g., federal form 4684 CASUALTIES AND THEFTS) for the year in which the NOL occurred.

Note: Effective January 1, 1994 moving expenses are no longer itemized deductions.

7. To claim a refund from a carryback of a Michigan NOL, complete and file form MI-1045 APPLICATION FOR NET OPERATING LOSS REFUND. If any of the refundable credits are affected by the NOL carryback, a copy of the revised credit claim form must be attached. Form MI-1040X (amended Michigan return) is no longer required to be attached to form MI-1045.
8. Be sure to attach a calculation of the amount of all NOLs included in the NOL deduction claimed on the Michigan return. If this information is not on file with the Department, it will have to write to the taxpayer and ask for it.
9. When completing form MI-1045, exclude income and losses from other states in Part 1.

GAMBLING INCOME

Income from gambling activities from Indian or privately held casino's games of chance, horse racing, lottery winnings, etc., is subject to Michigan income tax to the extent the winnings are included in federal AGI. Gambling losses cannot be deducted in determining Michigan taxable income.

Gambling losses may be deducted as a federal Schedule A itemized deduction to the extent of gambling winnings on the federal income tax return. However, itemized deductions are deductions from AGI and, therefore, are not included in federal AGI. Because the computation of Michigan taxable income begins with federal AGI, gambling losses cannot reduce Michigan taxable income. Cash prizes or merchandise won in Michigan may be deducted in determining Michigan taxable income. To qualify for the deduction, the prize must have been awarded by a Michigan licensed bingo game, millionaire party, or charity game conducted in conformity with the Traxler-McCauley-Bowman Bingo Act, Act 382 of 1972 as amended (MCL 432.101 through MCL 432.120). The amount of the deduction is limited to the amount of the prize included in federal adjusted gross income.

NOTE: Bingo games conducted in casinos are not regulated by the Traxler-McCauley-Bowman Bingo Act. Therefore, bingo prizes won in casinos are subject to Michigan income tax. As a rule, the exemption is only extended to games operated by charitable or nonprofit organization.

MILITARY PAY

Pay received by members of the U.S. armed forces is not subject to Michigan income tax. Military pay includes:

- Active duty pay and military retirement pay
- Reserve duty pay
- National Guard pay **only for the following:**
 - Weeknight and regular weekend drills
 - Summer camp
 - Pay received for riot duty **only if nationalized by the President of the U.S.**
- Public Health Officers pay only for those assigned to the Coast Guard or who are **nonresidents of Michigan.**

The W-2 form will show if individual's pay is active duty military pay. If the second set of digits of the employer identification number begins with 997, 998 or 999, the pay is military pay. Military pay may be subtracted on the Michigan return to the extent included in federal adjusted gross income.

Military pay does **not** include:

- W-2 forms from an Officer's Open Mess or similar establishment
- W-2 from the military showing an employer number identifying a civilian employee
- Wages paid to employees of the United States Property and Fiscal Office (USPFO)

- National Guard pay for the following:
 - Riot duty when called to duty by the Governor (paid by the State)
 - Full-time employment for which the taxpayer received a W-2 from the State.
- Resident Public Health Officers (employees of Health and Human Services) for other than the Coast Guard.

Note: Residency of military personnel and Public Health Officers remains with the state from which they entered the service unless they have filed a declaration with the service to change it.

HOMEOWNER'S PRINCIPAL RESIDENCE EXEMPTION

The Homeowner's Principal Residence Exemption Program, formerly known as the Homestead Exemption Program, allows homeowners an exemption from their local School Operating Millage (it lowers their property tax bill). In accordance with PA 237 of 1994, homeowners that occupy their property as their principal residence may be exempt from up to 18 mills.

Normally, when a home is purchased, the property owner files form 2368 HOMEOWNER'S PRINCIPAL RESIDENCE EXEMPTION AFFIDAVIT with the township or city assessor. The exemption is then posted to the local property tax roll.

This program is separate from the Homestead Property Tax Credit, which is filed annually with Michigan Income Tax Returns.

Homeowner's Principal Residence Exemption Records Review

In many cases, the local unit of government performs administrative audits of the Homeowner's Principal Residence Exemption records. PA 105 of 2003 allows county treasurers and equalization directors that have elected to "opt in" with the Department of Treasury to perform administrative audits of exemptions within their county. The Department performs administrative reviews of records for counties that don't conduct their own audits.

Periodically, the Department may contact the homeowner to request information to verify that the property under review was the principal residence for the years in question. Social security numbers are used to verify the tax exemption claim and to deter fraudulent filings.

Common reasons for the Department to request more information are:

- Failure to rescind an exemption when the property is sold (form 2602 REQUEST TO RESCIND HOMEOWNERS PRINCIPAL RESIDENCE EXEMPTION).
- The property in question was not a principal residence during the years in question.

- The homeowner is filing annual income tax returns from an address other than the address of their principal residence.

If a letter from the Department requesting more information is received, it is important to respond in writing. The homeowner's response must be received within 30 calendar days from the date on the letter. Failure to respond may result in a denial of the exemption.

Verifying Documentation

Factors to be considered in determining taxpayers' domiciles include where they keep their most important possessions, houses their family, votes, maintains club and lodge memberships, buys automobile licenses, maintains a mailing address and banks, operates a business, or sues for divorce. However, no one of these factors is controlling.

The documentation submitted must show that the property was the homeowner's principal residence for the year(s) in question, and must be dated between January 1 and May 2 for each year in question. Some examples of verifying documentation are a:

- Copy of driver's license with property address
- Copy of voters registration record
- Copy of a cancelled check listing the property address. Black out any information other than the address and the date the check was written.
- Copy of a bank statement, charge account statement, medical billing, etc. Only the portion identifying the address and date need be submitted.
- Copy of the income tax return indicating the mailing address.
- Copy of an insurance policy. Only the portion identifying address and date need be submitted.

If the taxpayer never owned the property or if the information on the letter is incorrect, make corrections on the letter and return it to the Department of Treasury.

Forms for Homeowner's Principal Residence Exemption

Forms are available on Treasury's Web site at www.michigan.gov/treasury.

NONREFUNDABLE CREDITS

City Income Tax Credit

A taxpayer is eligible for a credit based on income tax paid to a Michigan city during the tax year. The amount of city income tax used as the basis for the credit is the city income tax paid by the taxpayer in the tax year. For purposes of this computation, city income tax does not include penalties or interest paid. The amount paid must be reduced by any refund or overpaid taxes of a prior year.

If a person is assessed and pays additional city income taxes applicable to a prior year, the additional **tax only** may be added to the current year city income tax for the credit computation. A copy of the prior year return or other documentation of late payment should be included if the credit calculation includes delinquent city taxes.

Example 1: Donald lives in Lansing and paid \$285 city income tax during 2004 through city income tax withholding. In 2004 he received a refund of \$45 from the city of Lansing for an overpayment of his 2003 city income tax. The amount that he may use to calculate the credit for city income tax on his Michigan income tax return is computed as follows:

2004 Withholding	\$ 285
Less: 2003 Refund Received in 2004	<u>- 45</u>
Amount Eligible for 2004 Credit	\$ 240

Example 2: Sarah works in Flint and paid \$300 city income tax during 2004 through withholding. Sarah also paid \$44 tax with her 2003 Flint income tax return in April 2004. In June 2004, the city of Flint assessed Sarah \$265 tax, \$50 penalty, and \$25 interest for a prior year city tax return. Sarah paid the total assessment of \$340 in July 2004.

Sarah may use \$609 on her Michigan 2004 tax return to determine the city income tax credit computed as follows:

2004 Withholding	\$ 300	
2003 Tax Due With Return	44	(paid in April 2004)
Prior Year Tax Only	<u>265</u>	(paid in July 2004)
Amount Eligible for 2004 Credit	\$ 609	

Sarah may not include the penalty and interest paid to a Michigan city in the computation of the city income tax credit.

Public Contributions Credit

The public contribution credit is limited to the lesser of 50% of the contribution or \$100 for those filing single (\$200 for those filing jointly).

Credit is allowed for contributions to the following:

- State of Michigan (artwork donation only)
- Michigan municipality (artwork donation only)
- Michigan municipality if for benefit of an art institute with the municipality (monetary or artwork donation)
- Nonprofit corporation affiliated with both a municipality and an art institute if for the benefit of the art institute (monetary or artwork donation)
- State Art in Public Places Fund*
- Public Library
- Michigan public broadcast station not affiliated with an institution of higher education
- Michigan institution of higher education
- Michigan Colleges Foundation
- State of Michigan Museum
- Michigan Department of State for preservation of the State archives
- Nonprofit corporation, fund, foundation, trust or association organized and operated exclusively for the benefit of a Michigan institution of higher education and which is also controlled or approved and reviewed by the governing board of the institution which is benefiting from the charitable contribution.

*Must be for display in a public place. A public place means real property or an appurtenance to the real property which is owned by Michigan, a public agency, or a college or university in Michigan. It may include a structure, enclosure, facility, or complex, including a court, mall, park, or other area, feature, or element used by Michigan, a Michigan college or university, or other public agency in the conduct of the agency's business.

Credit for Income Tax Imposed by Qualified Government Units Outside Michigan

A Michigan resident is allowed a credit for income taxes imposed by another state of the U.S., a political subdivision (city, county, etc.) of another state, the District of Columbia or a Canadian province. Tax imposed on income that is also subject to Michigan tax may be claimed for the credit. You must attach a copy of the other state, city or county income tax return.

The credit cannot exceed the smaller of the amount of tax imposed by another state or the percentage of Michigan tax due on salaries, wages and other income earned and taxed in the other state. Credit is not allowed for taxes paid on income subtracted on the MI-1040 or on business income.

A Michigan resident who earned wages in a reciprocal state may pay a city or county tax in that state. The city or county income tax paid in that state may be claimed for the credit; however, the state income tax paid to the reciprocal state cannot be claimed.

A Canadian credit is allowed only if provincial tax was paid. The credit shall be allowed for that portion of the provincial tax not claimed as a credit for United States income tax purposes. Credit is **not** allowed on the Michigan return for that portion of provincial tax that is a carryover from a previous year or that is being carried over to a future year on the federal return.

PA 484 of 1996 amended Section 256 by repealing the credit against the Michigan income tax for income tax paid to the nonresident's state of residence. Therefore, a non-Michigan resident earning wages, salary, commissions or other personal service income in Michigan would not be allowed a credit against the Michigan income tax for income tax paid to his/her resident state.

Community Foundations Credit

The community foundations credit is limited to the lesser of 50% of the contribution or \$100 for those filing single (\$200 for those filing jointly). This is a nonrefundable credit. *See Revenue Administrative Bulletin 2003-5 on Treasury's Web site at www.michigan.gov/treasury.*

Homeless Credit

A nonrefundable credit is allowed on the Michigan income tax return for **cash** contributions to a qualifying shelter for homeless persons, food kitchen, food bank and other entities whose primary purpose is to provide overnight accommodation, food, or meals to persons who are indigent.

The credit is 50% of the cash contribution not to exceed \$100 for a single taxpayer or \$200 for a joint return. The cash contribution must be made to a Michigan organization.

Michigan Historic Preservation Income Tax Credit

This allows a nonrefundable credit based on 25% of qualified expenditures for the rehabilitation of a historic resource pursuant to a rehabilitation plan.

The claimant must claim the Historic Preservation Credit in the first year of eligibility.

Any unused portion of the credit may be carried forward for a maximum of 10 years.

The rehabilitation plan and the completed rehabilitation of the historic resource must be certified by the Michigan Historical Center.

PA 70 of 2001 removed the sunset date on the Historic Preservation Tax Credit under the Income Tax Act. This credit has only been available since 1999 and originally had a sunset date of January 1, 2003.

Michigan College Tuition and Fees Credit

A taxpayer may claim a credit against the income tax for tuition and fees paid on behalf of a student to a Michigan college or university. The amount of the credit is the lesser of 8% of the tuition and fees paid or \$375 for each student for the 2003 tax year. The credit cannot be claimed for more than 4 years for any one student.

To be eligible for this credit the **claimant** must:

1. Be a Michigan resident.
2. Have adjusted gross income of \$200,000 or less.
3. Have paid undergraduate tuition and/or fees on behalf of the student. (Fees must be those that are paid uniformly by all students.)

To qualify the **college or university** must meet the following requirements:

1. Be located in Michigan.
2. Certify by July 1 of the tax year that the ensuing academic year's tuition will not increase by more than the annual average percentage increase in the U.S. consumer price index in the immediately preceding tax year.
3. Meet the requirements of an Institution of Higher Learning as stipulated in MCL 206.260.
4. Include programs not exclusively comprised of sectarian instruction or religious worship.

A list of the eligible colleges and universities that meet the requirements is printed on the back of the Schedule CT Michigan College Tuition and Fees Credit.

The student(s) must be working on an undergraduate degree or certificate. Tuition and fees paid for graduate studies cannot be claimed for the credit. Tuition and fees paid by student loans can be claimed for the credit. However, tuition/fees paid by scholarships, grants, etc., cannot be claimed for the credit. In addition, the costs of books, room and board, parking, transportation, food, and other living expenses are not considered to be tuition/fees and cannot be used when calculating this credit.

The Michigan College Tuition Income Tax Credit is claimed on form MI-1040. Schedule CT must be attached to the MI-1040. The Department may require proof from the claimant to support the tuition and fees claimed in the calculation of this credit.

REFUNDABLE CREDITS

Household Income

Refundable credits require the computation of household income. Household income is defined in MCL 206.508(4) as “All income received by all persons of a household in a tax year while members of a household.” MCL 206.510 defines income as “. . . Federal adjusted gross income plus income specifically excluded or exempt from the computation of federal adjusted gross income.”

Items specifically excluded or exempt from the computation of AGI are generally income that will not be subject to tax in the year actually or constructively received or in a subsequent taxable year under the Internal Revenue Code (IRC) or by federal laws other than the IRC. Excluded or exempt income includes but is not limited to income described in Sections 101 through 134 of the IRC, exempt interest dividends, foreign income exclusion, etc.

Following is a **partial list** of excluded or exempt income that must be included in a claimant’s household income:

1. Social Security, SSI or railroad retirement benefits
2. Child support
3. Workers’ compensation
4. Veterans’ disability compensation and pension benefits
5. Family Independence Program (FIP) assistance and Family Independence Agency benefits (FIA)
6. Nontaxable sick pay or long-term disability benefits
7. Lump sum distribution that have been deducted from federal gross income
8. Gains realized on sale of residence
9. Awards, prizes, lottery, bingo and gambling winnings over \$300
10. Farmland preservation tax credit (if not included in farm income on line 16)
11. Amounts received for minor children or other dependent adults who live with claimant
12. Inheritance
13. Compensation for damages to character or for personal injury or sickness

14. Proceeds of a life insurance policy paid on the death of the insured
15. Death benefits paid by or on behalf of an employer
16. Minister's housing allowance
17. Scholarships, stipends, grants or GI bill benefits
18. Reimbursement from dependent care and/or medical care spending accounts
19. Value over \$300 in gifts of cash, merchandise or expenses paid on claimant's behalf (rent, taxes, utilities, food, medical care, etc.)
20. State Disability Assistance (STA) and State Family Assistance (SFA)
21. Repatriate Assistance and Refugee Assistance
22. Vendor payments for shelter, heat and utilities
23. Rollover amount from an IRA to a Roth IRA to the extent included in AGI
24. Foreign earned income exclusion
25. Accumulation distributions received from a trust not previously included in AGI.

Items not in household income (partial list):

1. Minor child's income
2. Loan proceeds
3. Refunds of state and local income tax
4. Homestead property tax credit
5. Original contributions to pension
6. Stipends received under Foster Grandparent Program
7. Deferred gains from sale of residence when the proceeds are reinvested in a new home
8. Inheritance from spouse
9. Life insurance benefits from a policy on claimant's spouse
10. Nontaxable dividend distributions that represent a return of capital
11. Relief in kind paid by a government unit to a third party.

Adjustments to household income:

1. Payments to IRA, Keogh (HR 10), SEP or SIMPLE plans
2. Student loan interest deduction
3. Medical savings account deduction
4. Medical insurance/HMO premiums claimant paid
5. Moving expenses when moving into Michigan
6. Deduction for self-employment tax
7. Self-employment health insurance deduction
8. Forfeited interest penalty for premature withdrawal
9. Alimony paid
10. Net operating loss (NOL) deduction (may not exceed federal modified taxable income)
11. Educational expenses
12. Tuition and fees deduction.

Property Tax Credit

An individual may claim a property tax credit if he or she is a resident of Michigan for at least six months of 2004, rents or owns a homestead located in Michigan as his or her principle residence, and the property is subject to ad valorem property tax. An individual can have only one homestead (domicile) at a time and must be the occupant as well as the owner or renter.

To claim the credit the taxpayer must first calculate household income. For practical purposes, household income is all taxable and nontaxable income of a husband and wife or a single person maintaining a household.

The property taxes **levied** on the homestead for 2004 are the only taxes that can be claimed for credit regardless of when the taxes are paid. These include additional taxes assessed or refunded that are attributable to a prior year such as the result of a Michigan Tax Tribunal decision or the reversal of a homestead affidavit denial. Also, collection fees of up to 1% of the property taxes and special assessments based on state equalized value and applied to the entire taxing jurisdiction may be included. Beginning in 2003, under the authority of PA 28 of 2003, if the special assessment is for police, fire or advanced life support, the credit may be taken even if the assessment does not cover the entire taxing jurisdiction.

Do not include:

- Penalty and interest on late payments of property tax
- Delinquent property taxes
- Delinquent water or sewer bills
- Property taxes on cottages or second homes
- Special assessments (for drains, sewers, etc.) that are not based on state equalized value and are not applied to the entire taxing jurisdiction
- 2003 taxes paid in 2004.

For general claimants, reduce the property taxes by 3.5% of household income. Then multiply the result by 60% to calculate the amount of the credit.

Michigan homestead property tax credit and homestead exemption refunds received in 2004 may be taxable on the 2004 federal income tax return. These are refunds of a portion of the property taxes paid. If the taxpayer claimed an itemized deduction for property taxes on a prior federal income tax return, and then received a refund in 2004 from the state or local unit of government for a portion of those taxes, a portion of that refund may need to be included as income on taxpayer's 2004 federal income tax return.

If questions about taxability (for federal tax purposes) of these refunds, call the IRS at 1-800-829-1040.

Example: Bill received wages of \$15,030, and his wife Mimsy received wages of \$7,542. They had an IRA deduction of \$2,000 on their federal return. The property taxes levied on their homestead in 2004 were \$1,789.

Bill's wages	\$ 15,030
Mimsy's wages	7542
IRA	<u>(2,000)</u>
Household income	20,572
x 3.5%	<u>720</u>
Property taxes for 2004	1,789
Less 3.5% of HHI	<u>720</u>
	1,069
	<u>x.60</u>
	\$ 641

Bill and Mimsy are entitled to a property tax credit of \$641 for 2004. If Bill or Mimsy were 65, then their property tax credit would be \$1,069 for 2004.

Reporting Taxable Value (TV) on Form MI-1040CR Homestead Property Tax Credit

The Michigan Department of Treasury requires the reporting of the TV of the property on the CR form to process property tax credit claims. To avoid possible refund delays, enter the TV on the proper line. Use the following list to determine the correct TV to report in special circumstances.

1. **If the taxpayer moves during the year**, complete the section "Homeowners," showing the TV for each homestead. If there were more than two homesteads during the year, attach an additional sheet. Leave line 7 on the CR form blank.
2. **If the taxpayer lives in a nursing home and the spouse lives in a homestead**, complete the section "Occupants of Nursing or Adult Foster Care Homes or Homes for the Aged" and combine the taxes for both residences on line 8.
3. **If the taxpayer's homestead is assessed at the non-homestead rate**, use the actual TV that is being assessed at the non-homestead rate on line 7.
4. **If the taxpayer lives in service fee housing**, leave line 7 blank. A schedule of explanation need not be attached.
5. **If a portion of the homestead is rented out or used for business**, show the total homestead TV on line 7. Reduce the property taxes by the greater of 20% of the gross rent collected or the amount of property taxes claimed as a business deduction on the U.S. 1040. Show the explanation either on the return or an attached schedule.

6. **If the property tax claim includes eligible contiguous vacant land**, include on line 7 the sum of the TVs for the homestead and all eligible vacant land. (See MI-1040 Instructions for the definition of eligible vacant land.)

Special Situations

Farmers

Farmers may include farmland taxes in the property tax credit claim if any of the following conditions apply:

- If agricultural gross receipts are greater than household income, all farmland property taxes including taxes on unoccupied farmland are eligible for the credit. However, taxes on farmland that is rented by or leased to another person and is not adjacent or contiguous to taxpayer's home is not eligible for the credit.
- If agricultural gross receipts are less than household income and taxpayer has lived in the home more than 10 years, the taxes on the home and the adjacent and contiguous farmland are eligible for the property tax credit.
- If agricultural gross receipts are less than household income and taxpayer has lived in the home less than 10 years, the taxes on the home and five contiguous and adjacent acres of farmland are eligible for the credit.

Agricultural Gross Receipts

"Agricultural gross receipts" means income derived from the business of farming. A taxpayer is engaged in the business of farming if he or she cultivates, operates, or manages a farm for gain or profit. A taxpayer who receives a rental which is based upon farm production is also engaged in the business of farming. However, a taxpayer who receives a fixed rental without reference to production is engaged in the business of farming only if he or she participates to a material extent in the operation or management of the farm. (*See IRS Reg. 1.175-3.*)

The taxpayer has participated to a material extent in the operation or management of the farm if any one of the following tests are met:

1. The owner does **three** of the following:
 - Advances, buys, or stands good for at least half the direct costs of producing the crops.
 - Furnishes at least half the tools, equipment, and livestock used in producing the crops.
 - Periodically advises and consults with the tenant.
 - Periodically inspects the production activities.

2. The landowner regularly and frequently makes or takes an important part in making management decisions substantially affecting the success of the enterprise.
3. The landowner works 100 hours or more spread over a period of five weeks or more in activities connected with producing the crop.
4. The landowner does things which, considered in their total effect, show that he or she is significantly and materially involved in the production of farm commodities.

The following decision table may be used to determine the land eligible to be claimed for Homestead Property Tax Credit. Find the taxpayer column that applies to your situation and then see below the double line for the amount of eligible property.

Taxpayer:					
Owens farm	Y	Y	Y	Y	Y
Meets gross receipts test (see above)	Y	Y	N	N	N
Lives on farm	Y	N	Less than 10 yrs.	10 yrs. or more	N
Eligible Property:					
All farmland (doesn't have to be contiguous unless rented to others)	X	X			
Home plus 5 acres*			X		
Home and all contiguous or adjacent unoccupied land				X	
None					X

*Renters also qualify under this category.

The definition of “homestead” for the property tax credit was amended in 1990 to exclude “unoccupied real property that is leased or rented by the owner to another person” [MCL 206.508(2)]. Therefore, the renter or lessor of farmland may not claim the rent paid when computing a property tax credit.

A Farmland Preservation Tax Credit must be included in household income. It should be reported on the schedule of household income in net farm income or other taxable income. Homestead Property Tax Credits, however, are not included in household income. If the Property Tax Credit was included in taxable farm income, it may be subtracted in determining household income.

Part-Year or Deceased Taxpayers, Annualization of Household Income for Phase-Out

A property tax or home heating credit claim made by a part-year resident or on behalf of a deceased taxpayer (unless claimed by surviving spouse) requires annualization of household income to determine if his or her annualized household income:

1. Exceeds the threshold which phases out a property tax credit, **or**
2. May require a senior citizen or a totally and permanently disabled person to use a higher percentage of household income to determine nonrefundable portion of property taxes. (In the final computation, only the claimant's actual household income is used.)

Example 1: A property tax credit is filed on behalf of a **deceased** claimant age 65 with no surviving spouse. Household income of \$6,230 and two exemptions are reported. Taxpayer owned a home and lived in Michigan for 155 days in 2004. Taxes levied for 2004 were \$1,865.

Claimant's annualized household income is $366/155 \times \$6,230 = \$14,703$.

Prorated property taxes are $155/366 \times \$1,865 = \783 .

Since annualized household income is over \$6,000, 3.5% of actual household income must be used when computing the property tax credit.

Prorated property taxes	\$ 783
Less 3.5% of \$6,230	<u>218</u>
Property tax credit amount	\$ 565

Example 2: A **part-year** Michigan resident who lived in Michigan for 265 days received Michigan household income of \$58,425. Total property taxes of \$3,866 were levied on the Michigan homestead.

Claimant's annualized household income is $366/265 \times \$58,425 = \$80,627$.

Prorated property taxes ($265/366 \times \$3,866$)	\$ 2,784
Less: 3.5% of actual household income (\$58,425)	<u>2,045</u>
Balance	739
Multiply by 60%	443
Less: Percentage of credit subject to phaseout provision ($70\% \times \$443$)	<u>310</u>
Property tax credit	\$ 133

Separated and Divorced Claimants

Spouses who file separate Michigan income tax returns but share a household are entitled to only one property tax credit. Complete the property tax credit claim jointly and include both spouses' income. Then divide the credit as you wish. If each spouse claims a portion of the credit, attach a copy of property tax claim showing the share claimed. Two homesteads may be used for credit only if the couple is separated or divorced, each maintains a separate homestead, and each files separate federal and Michigan income tax returns. If the taxpayers file a joint federal return, then they must file a joint Michigan return.

Example: Jack and Rose were separated March 1, 2004 and divorced December 2, 2004. Rose stayed in the marital home all year, and Jack rented an apartment beginning March 1, 2004. Jack paid Rose \$300 (half the house payment) from March through December 2004 and 40 weeks of child support at \$160 a week. Property tax bills for 2004 on the marital home were \$2,850. Jack rented his apartment for \$500 a month. Their income before and after separation are as follows:

Wages:	Jack	Rose
January 1 - February 28	\$ 7,200	\$ 5,000
March 1 - December 31	\$36,000	\$ 25,000

Complete a Michigan Homestead Credit for each spouse based on the above information.

First calculate the property taxes that can be claimed for credit by each spouse prior to separation.

Income prior to separation:

Wife	\$ 5,000
Husband	<u>7,200</u>
Total	\$12,200

Percent of income prior to separation:

Wife	$\$5,000/\$12,200$	=	41%
Husband	$\$7,200/\$12,200$	=	59%

2004 taxes prorated for period
prior to separation

$$\$2,850 \times 2/12 = \$ 475$$

Percent claimed before separation:

Wife	$\$ 475$	x	41%	=	$\$ 195$
Husband	$\$ 475$	x	59%	=	$\$ 280$

Wife's total taxes claimed for credit
(lived in the family home for the entire year):

Before separation	$\$ 475$	x	41%	=	$\$ 195$
After separation	100%	x	$(\$2,850 - \$475)$	=	<u>$2,375$</u>
					$\$2,570$

Husband's total taxes claimed for credit:

Before separation	$\$ 475$	x	59%	=	$\$ 280$
After separation - Rent paid	$\$ 5,000$	x	20%	=	<u>$\\$1,000$</u>
					$\$1,280$

Note: Rose must include both the house payments made by Jack of \$3,000 as well as the child support of \$6,400 in household income. Jack, however, may deduct the \$3,000 alimony/separate maintenance payments in determining household income but not the \$6,400 child support. The Federal Code dictates that child support not be deducted in arriving at adjusted gross income. Household income by definition is the sum of adjusted gross income plus all specifically exempted and excluded income.

Nursing Home, Home for the Aged and Adult Foster Care Claimants

A permanent resident of a nursing home, home for the aged or foster care home is entitled to a homestead property tax credit if the facility bills a lump sum for rent and services. The resident's allocable share is calculated by dividing the facility's property tax by the number of licensed beds.

If the facility receives a direct payment from a state or federal agency for the care of the resident, then the allocable share may be limited. The resident cannot claim an allocable share that is greater than the charges paid by the resident to the facility.

Example: Mrs. Wood’s nursing home charges were billed in a lump sum of \$12,500 (for rent, food and other nursing services) to the State of Michigan. Of that sum \$12,000 was paid directly to the nursing home by the state. Mrs. Wood paid the balance due of \$500.

Mrs. Wood’s “allocable share” of property taxes on the nursing home, based on 100 beds and \$60,000 in real property taxes, is \$600. Since Mrs. Wood’s total charges paid by her are less than her “allocable share,” she may use only the lesser amount of \$500 for calculating a property tax credit.

Room and Board

If the claimant pays room and board in **separate** billings, the claimant must base the credit on the rent. If the claimant pays room and board in **one** billing, the credit must be based on a prorated share of the property taxes on the facility. If the landlord does not provide this figure, divide the square footage of the claimant’s living space by the total square footage of the facility, and multiply the total taxes on the facility by that percentage.

Special Housing

If the claimant resides in housing where the rent includes meals and other services (housekeeping, laundry, transportation, etc.), the credit must be based on the prorated share of the taxes on the entire property. The facility must provide the claimant with the prorated share of the property taxes for use in the credit calculation. Claimants may not calculate the credit by using the portion of the monthly payment as rent.

Service Fee Housing

If the claimant lives in housing on which service fees are paid instead of taxes, 10 percent of the rent can be claimed for credit. If the landlord says the claimant’s share of the taxes is less than 10 percent, use the amount given by the landlord.

Recipients of FIA Payments and Child Support Payments

Section 206.520(7) of the Michigan Compiled Laws allows recipients of Family Independence Agency (FIA) payments to reduce the amount of FIA benefits reported to them when the amounts include child support payments assigned by the Friend of the Court.

The annual statement from FIA may include child support payments made through the Friend of the Court to FIA. To determine the child support payments included in the statement, obtain a Fourth Quarter Statement from the Office of Child Support. This statement is mailed to all recipients of FIA payments. The amount reported as support is child support payments sent to FIA, and the amount reported as rebates paid is direct child support paid to the recipient.

Since the homestead property tax credit is prorated based on the percentage of income from FIA benefits, it is to the recipient's advantage to reduce the annual FIA benefits received by any child support included in this statement. The Fourth Quarter Statement from the Office of Child Support and, if available, a copy of the annual statement from FIA should be attached to the claim.

Example 1: A claimant received FIA benefits of \$12,000 in 2004, which included child support payments of \$3,000 assigned by the Friend of the Court to the Family Independence Agency. If the claimant's household income consisted solely of FIA benefits, he or she would not be entitled to a homestead property tax credit. However, since one-quarter of the total FIA benefits were from child support payments assigned to FIA, he or she is entitled to one-quarter of the homestead property tax credit computed.

Example 2: Taxpayer receives the following for 2004:

2004 annual statement from FIA	\$8,165	
Letter from Office of Child Support or Friend of the Court:		
Support	\$7,492	
Rebates paid	600	
To compute the household income:		
Annual statement from FIA	\$8,165	
Rebates paid	<u>600</u>	
	8,765	
Less support paid to FIA	<u>7,492</u>	
Annual FIA benefits actually received	1,273	(FIP/FIA line)
Child support	<u>7,492</u>	(Child Support line)
Household income	\$8,765	

Shared Housing

When two or more single people share a home, each can file a credit claim if each has contracted to pay rent or owns a share of the home. Each should file an individual claim based on his or her household income and prorated share of the taxes or rent paid.

Example 1: Walt and Ken own a home in Brighton, Michigan. Both occupy the home and share the expenses for upkeep of the home. The property taxes on the home for 2004 are \$4,000. Dan and Fred would each claim \$2,000 of property taxes on their respective property tax credits. They would each show the full taxable value of the home and write on the form “shared housing” and the percent of property taxes being claimed.

Example 2: Michael owns and occupies his home in Midland. He fixed up the basement and rents it for \$400 a month to Barb. Michael would be eligible to claim a property tax credit on the taxes billed on his home for 2004; however, he would have to reduce property taxes by the greater of 20% of the gross rent received or the amount of property tax claimed as a business expense on his federal return.

Example 3: Paul and Joseph rent a home from Julie. Both names are on the contract. Monthly rental of the home was \$950; total paid during 2004 was \$11,400. All rent and expenses were split evenly between the men. Paul and Joseph would be eligible to claim a property tax credit on their share of the rent paid.

Farmland Preservation Tax Credit

The CR-5 form was redesigned to include Schedule CR-5. The design allows more space to list all agreements and corresponding taxes. The agreement (or contract) number is found in the lower-right corner of each agreement. The first two numbers represent the county where the property is located. The middle set of numbers is the actual contract number. The final six numbers are the year of expiration, e.g., 123102 (December 31, 2002). The actual contract number retains its original series throughout the term of the agreement. However, a letter of the alphabet may be added to indicate that the agreement was split into multiple agreements. The final six numbers change as the agreement is reduced or extended. **Always use the contract number on the most recently recorded agreement. The expiration date may never be earlier than the year of the return being prepared.**

Schedule CR-5 must be completed. Use more than one form as needed. The system will not accept a substitute Schedule CR-5 in lieu of the State of Michigan Schedule CR-5. The entire Taxable Value for each claimed agreement must be entered on the Schedule CR-5 in the space provided. This is required even if the taxpayer is eligible to claim only a portion of the property taxes because of joint ownership(s), partnership(s), or multiple shareholders. The Taxable Value can be found on the property tax statements for each parcel.

Eligibility

This credit is provided for under Public Act 116 of 1974. This Act enables a landowner to enter into a development rights agreement (for farmland) with the State of Michigan. The agreements are designed to ensure that the land remains in agricultural use for an agreed-upon period. In return for maintaining the land in agricultural use, the landowner is entitled to certain income or property tax benefits.

The Farmland Preservation Tax Credit refunds to farmland owners the taxes in excess of 3.5% of their household income on property covered by a Farmland Development Rights Agreement (FDRA) with the Michigan Department of Agriculture.

Tips To Expedite Processing

- List the entire Taxable Value of an agreement regardless of the percentage of the agreement being claimed.
- Ownership indicated on property tax statements must also match ownership in PA 116 agreement(s). If the claimed agreement does not reflect appropriate ownership, the credit may be reduced or denied.
- Multiple names on property tax statements indicate joint ownership. The taxpayer may not claim 100% without a signed distribution statement from all other owners. The agreement may be reduced or denied without the signed statement.
- Farmland agreement numbers consist of:
 - **County Code** - indicated by the first two digits of the agreement number.
 - **Expiration Date** - indicated by the last six digits of the agreement number. The first four digits are always “1231.” The last two digits are comprised of the year the agreement is to expire (e.g., “123107”). The expiration year may never be earlier than the year of the return being prepared.
 - **Contract Number** - indicated by the set of the numbers between the county code and expiration date. These numbers may or may not include a letter depending on whether the agreement has been split.
- When farmland agreement numbers contain alpha characters, the alpha characters belong after the contract number but before the expiration date.
- If the expiration year entered is prior to the current tax return year, the agreement is expired and may no longer be claimed. The taxpayer must extend the agreement and provide the new expiration year before the agreement may be claimed again.
- It may be beneficial to have the taxpayer provide copies of the agreements being claimed for accuracy and to avoid processing delays.
- An MI-1040-CR or CR-7 must be filed to claim a PA 116 credit even if it results in a zero credit. The Schedule of Household Income provided on these forms is used to verify the household income used in computing the farmland credit.
- Each agreement should only appear on one line of the Schedule CR-5. Multiple parcels for a single PA 116 agreement must be combined to determine the entire agreement’s eligible taxable value and the eligible property taxes.

- Only the portion of the tax bill that is used for agricultural purposes may be claimed for credit regardless of the amount of the parcel that is enrolled in the PA 116 program. The qualifying portion of the parcel will be indicated on the property tax statement(s) as an agricultural or homestead percentage. Follow the instructions in the MI-1040CR-5 tax booklet under the “Property Taxes That Can Be Claimed For Credit” section to compute the eligible taxes if the bill indicates less than 100% exempt.

Computation of the Value of the Lien Imposed Upon Removal of Land From Farmland and Open Space Program

When property is removed from the Farmland and Open Space Program, the State Land Use Agency records a lien against the property. Land may be relinquished from the program for the following reasons:

1. Natural expiration of the agreement.
2. Death or permanent disability of the landowner.
3. Landowner requests relinquishment of all or a portion of an agreement.

The lien value may be computed differently based on the reason the land was relinquished. The following discussion outlines the computations required by the different ways the Farmland Development Rights Agreement are relinquished.

1. Natural termination of agreement.

The value of the lien will be the amount of the farmland preservation credits attributable to the terminated agreement received by the owner in the final seven years. The final seven years shall include the year of termination. The value is computed as follows:

Step 1

- Divide: The ad valorem property tax levied on property subject to the expired development rights agreement that was used in determining the farmland preservation credit in that year
- By: The property taxes levied on property subject to all development rights agreements used in determining the farmland preservation credit in that year.

Step 2

- Multiply: The owner’s total farmland credit on all agreements paid that year
- By: The quotient in Step 1.

Step 3

Sum: The results of Step 2 may or may not be used for each of the last seven years, depending on agreement number and property taxes assessed.

2. **Landowner dies or becomes permanently and totally disabled, and a request has been granted for the release of all property covered by the development rights agreement.**

The value of the lien will be the total amount of the farmland preservation credit received by the owner for the payback period. The payback period and value of the lien is computed as follows:

Payback Period

Step 1

Divide: The number of years the land was enrolled in the current development rights agreement

By: The number of years for which the agreement was written.

Step 2

Multiply: Seven years

By: The quotient computed in Step 1.

Value of the Lien

Step 1

Divide: The ad valorem property tax levied on property subject to the development rights agreement being relinquished that was used in determining the farmland preservation credit

By: The property taxes levied on property subject to all development rights agreements used in determining the farmland preservation credit in that year.

Step 2

Multiply: The owner's total farmland preservation credit on all agreements claimed that year

By: The quotient computed in Step 1.

3. **Landowner dies or becomes permanently and totally disabled, and a request has been granted for the release of a portion of land covered by the development rights agreement.**

The value of the lien will be the total amount of the farmland preservation credit received by the owner for the payback period. The payback period and value of the lien is computed as follows:

Payback Period

Step 1

Divide: The number of years the land was enrolled in the current development rights agreement

By: The number of years for which the agreement was written.

Step 2

Multiply: Seven years

By: The quotient computed in Step 1.

Allocated Credit of Entire Agreement

Step 1

Divide: The ad valorem property tax levied in that year on property subject to the development rights agreement that included the property to be removed

By: The total property taxes levied on property subject to all development rights agreements used in determining the farmland credit in that year.

Step 2

Multiply: The owner's total farmland preservation credit in that year on all agreements

By: The quotient in Step 1.

Value of the Lien

Step 1

Divide: The taxable value of the property being relinquished from the agreement

By: The total taxable value of the property subject to the development rights agreement that included the property being removed from the agreement.

Step 2

Multiply: The “allocated tax credit” of entire agreement

By: The quotient computed in Step 1.

4. **Landowner requests relinquishment of all or a portion of an agreement as provided by Section 36111(2)(a)(b) and 36111(a).**

Termination of All Land Covered by a Development Rights Agreement

Step 1

Divide: The ad valorem property tax levied on property subject to the development rights agreement to be relinquished that was used in determining the farmland preservation credit in that year

By: The property taxes levied on property subject to all development rights agreements used in determining the farmland preservation credit in that year.

Step 2

Multiply: The owner’s total farmland credit on all agreements paid that year

By: The quotient in Step 1.

Step 3

Sum: The results of Step 2 plus 6% per annum interest for each of the last seven years.

Termination of a Portion of Land Covered by a Development Rights Agreement

Step 1

Divide: The ad valorem property tax levied in that year on property subject to the development rights agreement that included the portion to be relinquished

By: The total property taxes levied on property subject to all development rights agreements used in determining the farmland credit in that year.

Step 2

Multiply: The owner's total farmland preservation credit in that year on all agreements

By: The quotient in Step 1. This is the "allocated tax credit."

Value of the Lien

Step 1

Divide: The taxable value of the property being released from the agreement

By: The total taxable value of the property subject to the development rights agreement that included the property being released from the agreement.

Step 2

Multiply: The "allocated tax credit" for the agreement

By: The quotient computed Step 1.

Step 3

Sum: The results of Steps 1 and 2 plus 6% per annum interest for each of the last seven years.

Sale of Land

From January 1 to the day of closing the seller (and conceivably his or her predecessor(s) in title) is the owner of the farmland.

For the period from January 1 to the day of closing the seller is the person responsible for the ad valorem taxes. For income tax purposes the IRS concludes the seller, not the buyer, pays the taxes (if the taxes are paid).

Similarly, the buyer is the owner of the farmland and is responsible for the payment of taxes (if paid) from the period of the "closing day" to December 31.

Based on the above, each owner is entitled to claim the credit for that portion of the calendar year he or she held title to the farmland.

Reinstatement of a Development Rights Agreement

If there is a lapse of time between the expiration and reinstatement of an agreement, the landowner is not eligible to claim a farmland preservation credit for the time the agreement had expired. The lien, which is recorded when an agreement is terminated, is discharged upon reinstatement of the development rights agreement. A subsequent lien will not be less than the lien discharged due to reinstatement.

Farmland Preservation Credit When Land Is Inherited

The taxpayer who inherited the land is not eligible for the credit until he or she is the owner of record and the development rights agreement is transferred to him or her by the State Land Use Agency.

Taxable Portion of Farmland Preservation Tax Credit

Taxable income for Michigan income tax purposes is defined in Michigan's Income Tax Act, MCL 206.30(1), as adjusted gross income as determined in the Internal Revenue Code subject to certain adjustments. To the extent that a farmland preservation property tax credit is includable in an individual's adjusted gross income, this income is taxable to this State. There is no statutory provision to exclude this income from the computation of Michigan taxable income.

Household income is described in Michigan's Income Tax Act, MCL 206.510(1). It is defined as the sum of Federal Adjusted Gross Income, as established in the Internal Revenue Code, plus all income specifically excluded or exempt from the computation of the Federal Adjusted Gross Income. Income does not include payments or credits under MCL 206.510(1). A farmland preservation tax credit is provided for in the Farmland and Open Space Preservation Act, **not the Income Tax Act**.

The part of the homestead property tax credit that applies to farm buildings and land is business related. To determine the portion that is business income, multiply the credit by the percentage that the state equalized value (SEV) of the buildings and land is to the total SEV of the property (see example).

The local assessor can provide a breakdown showing how total SEV was determined.

$$\begin{array}{l} \text{SEV of Farmland} \\ \text{Portion of Homestead} \\ \text{and Buildings} \\ \hline \text{Total SEV} \\ \text{That Is Business Income} \end{array} \quad \times \quad \begin{array}{l} \text{Homestead Property} \\ \text{Credit Amounts} \\ \text{Received This Year} \end{array} = \text{Property Tax Credit}$$

The farmland preservation tax credit amount and the business portion of the homestead property tax credit received during the year must be included in taxable income.

If, however, the MI-1040 tax refund was greater than the amount of farmland preservation credit plus the business portion of the homestead property tax credit, subtract the excess refund amount received during the year to the extent that it was included in federal adjusted gross income.

Attaching Property Tax Statement(s) When Claiming a CR-5

For All E-Fileers: Indicate in the space provided on SCHEDULE CR-5 if the property taxes are paid for the year of the return or for the immediately preceding year. No property tax statements are required at this time. However, keep them with the tax records, as there may be a need in the future for the Department to request them.

For All Paper Filers: Indicate in the space provided on SCHEDULE CR-5 if the property taxes are paid for the year of the return or for the immediately preceding year. You **must** include property taxes statements for the year of the return. These statements must include the taxable value, property taxes levied by millage rate, and the corresponding agreement number(s). If the tax statements do not indicate payment of property taxes and you have marked “YES” in the payment box of the Schedule CR-5, a copy of the previous year’s property tax receipt(s) indicating payment is also required.

Note: A “Yes/No” box must be checked for each agreement whether you e-file or paper file. If neither box is checked, it will be assumed the property taxes are not paid nor are receipts attached. This will result in the farmland credit being issued jointly payable to the taxpayer and the appropriate county treasurer.

Farmland Taxes Eligibility Chart

The following chart describes who may claim the farmland preservation credit and what taxes are to be used in computing the farmland credit based on ownership of the land.

<u>Type of Ownership</u>	<u>Taxes Based On</u>	<u>Must Attach</u>	<u>Effective Date</u>
Partnership	<ol style="list-style-type: none"> 1. Percent of income or ownership, or 2. Statement signed by all partners listing allowable percent for each partner 	<ol style="list-style-type: none"> 1. Federal 1065, K-1, and Schedule K, or 2. Partnership agreement, or 3. Signed statement, or 4. Completed part 4 of CR-5 	1/1/84
S Corporation*	<ol style="list-style-type: none"> 1. Percent of stock ownership 	<ol style="list-style-type: none"> 1. Federal 1120S and Schedule K 	1/1/88

*Single Business Tax filers do not qualify.

<u>Type of Ownership</u>	<u>Taxes Based On</u>	<u>Must Attach</u>	<u>Effective Date</u>
Joint (Other Than Spouse)	<ol style="list-style-type: none"> 1. Equal apportionment among owners, or 2. Statements signed by owners apportioning taxes the same way the revenues and expenses are divided 	<ol style="list-style-type: none"> 1. Signed statement, or 2. Completed part 4, or CR-5 signed agreement 	1/1/84
Life Estate or Life Lease	<ol style="list-style-type: none"> 1. Possession, or apportionment between owner and life estate holder 		1/1/86
Grantor Trust	<ol style="list-style-type: none"> 1. Ownership 	<ol style="list-style-type: none"> 1. Portion of trust that shows owner, or the deed 	1/1/84
Trust Created by Death of Spouse	<ol style="list-style-type: none"> 1. Ownership 	<ol style="list-style-type: none"> 1. Portion of trust that shows owner, or the deed 	1/1/84
Limited Liability Company	<ol style="list-style-type: none"> 1. Based on member's share of ownership or distributive share of ordinary income as reported by company to IRS 	<ol style="list-style-type: none"> 1. Limited liability company's federal return and schedules 	1/1/96

Repayments Under the Claim of Right Doctrine

Section 265 of the Michigan Income Tax Act allows taxpayers to claim a credit against the Michigan income tax equal to the amount of tax paid on amounts included in taxable income in a prior tax year and repaid in the current tax year.

The credit is allowed on amounts which qualify under Section 1341 of the IRC, and are not deducted in arriving at federal adjusted gross income for the tax year.

Example: Included in Ron's 2003 adjusted gross income was \$10,000 in Supplemental Unemployment Benefits (SUB pay) from ABC, Inc. In 2004, Ron repaid the \$10,000, as it was determined that he did not have the right to receive the SUB pay. The 2004 repayment qualified under Section 1341 of the IRC and was taken as an itemized deduction by Ron on his 2004 federal Schedule A. For the 2004 tax year, Ron is allowed a \$400 ($\$10,000 \times .04$) credit against his Michigan income tax. Calculate the credit using the tax rate in effect for the year the amount was included in Michigan taxable income (4.0%), not the lower rate (3.95%) in effect for 2004 the year of the repayment. Report the credit on the line for reporting withholding taxes. Write the words "Claim of Right/Repayment" next to the withholding line. Attach a copy of Ron's federal Schedule A, documentation of the repayment, and a calculation showing how the credit was determined on his 2004 MI-1040.

Adoption Credit

The Adoption Credit allows an eligible taxpayer to claim an adoption credit against the tax imposed by the Act that is equal to the taxpayer's qualified expenses that are in excess of the amount of credit for qualified adoption expenses the taxpayer claimed under Section 23 (Adoption Expenses) of the Internal Revenue Code (IRC) **or \$1,200** per child, whichever is less.

"Eligible taxpayer" is a taxpayer who has claimed a credit under Section 23 (Adoption Expenses) of the IRC for the same tax year in which the taxpayer is claiming an adoption credit on the Michigan income tax return. The adjusted gross income on the MI-1040 must be less than \$192,390 for tax year 2004.

"Qualified adoption expenses" are those expenses that are eligible to be claimed as a credit under Section 23 of the IRC for the same tax year.

If there are no excess federal adoption expenses or no federal adoption credit taken, there is no Michigan credit.

Home Heating Credit

Public Act 169 of 2001 allows a Home Heating Credit only if there has been a federal appropriation for the federal fiscal year beginning in the tax year of federal low income home energy assistance program block grant funds of any amount. Also under Public Act 169 of 2001, no portion of the credit allowed shall be applied as an offset to any liability of the claimant.

The deadline of the Home Heating Credit **must be filed and postmarked no later than September 30** of the following year. The amount of the credit may be prorated depending on the amount of federal funds appropriated.

An eligible claimant for a heating credit is defined as a renter or owner of a home. In addition the claimant's income must be within the income limits listed on the eligibility charts on the back of the MI-1040CR-7 form. An ineligible claimant is a person who lives in a home and does not pay rent or is not an owner. The standard allowance of heating costs is prorated for eligible claimants if the home is occupied by ineligible claimants. Other ineligible claimant's include:

1. Full-time students claimed as dependents by another person
2. Residents of a congregate care facility (i.e., nursing home, foster care home, home for the aged, substance abuse center, etc.) who resided in the care facility for the entire year.

For individuals who rent their homestead, if at the time of filing their heating costs are included in their rent or if the heat is in someone else's name, the credit must be reduced by 50%.

Example: A Michigan resident whose heat is included in his or her rent claimed a 2004 home heating credit. Two federal exemptions were reported. The claimant's household income of \$7,475 included wages of \$3,025, FIA benefits of \$1,500, and child support of \$ 2,950. The claimant may claim a home heating credit of \$110.

To compute the home heating credit:

Standard allowance	\$ 482
Less HHI multiplied by 3.5%	<u>262</u>
Standard credit	\$ 220
Renters reduce credit by 50%	\$ 110
Credit allowed	\$ 110

When two or more taxpayers (not related as husband and wife) share a home, each can claim a home heating credit if each has contracted to pay rent or owns a share of the house. If they share a home but are not the owners or have not contracted to pay rent, then they cannot claim a home heating credit.

To claim a credit, each eligible claimant should file a home heating credit based on his or her household income and his or her share of the standard allowance. The standard allowance is determined from Table A on the back of the form by adding the personal exemptions of all the claimants sharing the home.

Example: Two women share an apartment. Each person has signed a lease and pays one-half of the rent in 2004. The standard allowance for two exemptions is \$482. Each person must use a standard allowance of \$241 ($\$482/2 = \241) to compute the credit.

If one of the individuals sharing the home is eligible for a special exemption or a dependent exemption, then she would compute her credit as follows:

The standard allowance as computed above is \$241. Then add the difference between the standard allowance for three (\$604) and the standard allowance for two (\$482) to \$241 ($\$604 - \$482 = \$122 + \$241 = \$363$). \$363 is the standard allowance for the individual with the dependent exemption.

Part-year residents or claimants filing on behalf of deceased taxpayers must prorate the standard allowance based on the number of days the taxpayer was a Michigan resident.

Example: A 2004 home heating credit* claim is filed by a **part-year** Michigan resident who resided in Michigan for 198 days. The claim is based on Michigan household income of \$3,500 and one exemption.

Prorated standard allowance ($198/366 \times \$359$)	\$ 194
Less: 3.5% of actual household income (\$3,500)	<u>123</u>
Home Heating Credit	\$ 71

*No annualizing of household income is required when computing a home heating credit.

RELIEF FROM TAX LIABILITY

Non-Obligated Spouse Allocation

Michigan Compiled Laws Chapter 205, Section 30a, permits spouses to apportion a joint refund as though they had filed separate returns when one spouse has a liability. A non-obligated spouse's share of the refund will not, under certain conditions, be used to offset an obligated spouse's debt.

A spouse not responsible for the liability may obtain his or her share of the refund by completing and filing form 743 INCOME ALLOCATION FOR NON-OBLIGATED SPOUSE. This form is used to determine an overpayment based on separate reporting of income, credits and exemptions. **Form 743 is issued after the processing of the income tax return and CANNOT be obtained in advance.**

Form 743 must be signed by both spouses and returned within 30 days from the date the form was mailed by the Department of Treasury. If it is not filed within this period, a portion or all of the joint refund will be used to offset the obligated spouse's liability. If the 743 is returned to the Department but is incomplete, the entire refund will be offset. Once the 743 is filed it cannot be amended. A non-obligated spouse will **not** be permitted to commence an action to recover any amount withheld to satisfy the debt if they failed to properly file this form. Form 743 should be filled out even if the taxpayer is unsure of the debt or is contesting the debt.

If the obligated spouse's signature cannot be obtained, the form may still be filed but must list the reason why the obligated spouse's signature is missing.

Complete form 743 using the figures from the original return even if you discover that the Michigan income tax return needs to be amended. Do **not** attach form 743 to an amended return as the processing of the original refund will be delayed. The taxpayer may later file an amended return taking into consideration the refund requested on the original return.

Falsely reporting any information on form 743 will result in a penalty of \$25 or 25% of the excessive amount claimed, whichever is greater.

Relief From Joint and Several Liability on Joint Returns (Formerly Known as Innocent Spouse)

Innocent spouse relief, separation of liability and equitable relief may be granted by the Department for the portion of the tax liability that is attributable to the understatement of tax or the underpayment of tax. The Department shall use the standards set forth in Internal Revenue Code Section 6015 and related federal interpretation in matters regarding relief from joint and several liability.

Individuals requesting relief shall provide information regarding spousal relief that has been granted for federal income tax liability or other documentation or information to support the individual's request.

FIDUCIARY INFORMATION

General Information

A copy of the U.S.1041 must be filed with the MI-1041, and Schedules 1, 2 and 3 must be completed, if applicable. Schedule 4 must be completed if the estate or trust is filing as a nonresident.

An MI-1041 estate return must be filed on behalf of the estate of the deceased to report any income received after the date of death. An estate return is only entitled to the federal exemption allowance of \$600.

Resident Estate or Trust

Form MI-1041 MICHIGAN FIDUCIARY INCOME TAX RETURN must be filed if a U.S. 1041 return was filed or if there was income taxable to Michigan that was not included on the Federal 1041 (such as interest and dividends income from obligations of states other than Michigan).

Nonresident Estate or Trust

Form MI-1041 must be filed if income or gain from Michigan sources exceeds federal fiduciary exemptions. (This would include: income or gain from real or tangible personal property located in Michigan; income from business, trade, profession or occupation conducted in Michigan; income from services performed in Michigan; or income earned, received or acquired in Michigan.)

Grantor Trust

Michigan does not require a grantor trust to file form MI-1041 when the grantor is a trustee and is treated as the owner of the trust's assets per the Internal Revenue Code (IRC). Instead, report the trust's income, deductions, and credits on the grantor's income tax return (form MI-1040). (*See IRC Reg 1.671-4.*) The fiduciary, in addition to not being required to file an MI-1041, would not be required to provide copies of Federal returns or Federal Schedule K-1's for the above grantor trust.

A grantor type trust is a legal trust under applicable State law that is not recognized as a separate taxable entity for income tax purposes, because the grantor or other substantial owner has not relinquished complete dominion and control over the trust.

See IRC Sections 671 through 678 for more information on the characteristics of grantor type trusts.

Allocation of Michigan Net Adjustments to Trust Beneficiaries

A beneficiary must attach Schedule K-1 or a letter from the fiduciary to his or her MI-1040 return. The K-1 or the letter must show the name of the trust, federal identification number, and the income and Michigan adjustments to be included on the beneficiary's MI-1040 and 1040D.

The allocation of Michigan net adjustments must be in proportion to the beneficiary's respective share of distributable net income of the estate or trust as defined in the Internal Revenue Code.

If the estate or trust has no distributable net income for the taxable year, refer to MCL 206.36(2).

MCL 206.36(2) of the Michigan Income Tax Act states:

“The respective shares of an estate or trust and its beneficiaries, including, solely for the purpose of this allocation, nonresident beneficiaries, in the additions and subtractions to taxable income shall be in proportion to their respective shares of distributable net income of the estate or trust as defined in the internal revenue code. If the estate or trust has no distributable net income for the taxable year, the share of each beneficiary in the additions and subtractions shall be in proportion to his share of the estate or trust income for the year, under local law or the terms of the instrument, which is required to be distributed currently and any other amounts of such income distributed in the year. Any balance of the additions and subtractions shall be allocated to the estate or trust. If capital gains and losses are distributed or distributable to a beneficiary or beneficiaries under the internal revenue code, the fiduciary shall advise each beneficiary of his share of the adjustment under section 271. The election or failure to elect under section 271 with respect to capital gains and losses taxable to the estate or trust shall not affect the beneficiary’s right to elect or not elect under section 271.”

There will be occasions where the additions or subtractions would be attributable to capital gains that were not distributed. The taxpayer should identify any additions or subtractions attributable to the capital gains or losses that were not distributed according to the same percentage as the distributable net income.

Taxable Income of Nonresident Beneficiary of Michigan Trust

A nonresident beneficiary’s taxable income is subject to the allocation and apportionment rules of the Michigan Income Tax Act. There is no longer an exclusion for the income passed through to a nonresident beneficiary from a Michigan trust if the income is allocable or apportionable to this State under the provisions of Chapter 3 of the Income Tax Act.

IRS MATCH

The IRS provides the Michigan Department of Treasury with information regarding taxpayers’ federal tax returns in accordance with section 6103(d) of the Internal Revenue Code. Following is a summary of the IRS match programs.

The delinquent match program identifies taxpayers who filed their federal income tax returns from a Michigan address but did not file Michigan returns. Treasury sends these taxpayers a letter of inquiry requesting that a Michigan income tax return be filed. The letter indicates the amount of tax that is due based on the reported federal adjusted gross income and federal exemption allowances.

The AGI match program identifies taxpayers who reported a different amount of adjusted gross income on their federal income tax returns than on their state income tax returns. Treasury sends a letter of inquiry to the taxpayers indicating the amount of AGI reported on their federal return and the Michigan return. Tax due is computed on the difference between the federal and state return. Since household income is affected, the property tax credit and home heating credit (if applicable) are recomputed adding the difference to the amount due.

The CP 2000 program identifies taxpayers who failed to report income that was reported to the IRS by third parties. Treasury sends a letter of inquiry to the taxpayers indicating the source and the amount of the unreported income, as well as the amount of income tax and interest due on that income.

The IRS reports the results of all audits conducted on individuals who are Michigan residents. This information is then matched against amended returns filed by the taxpayers. If discrepancies exist or if amended returns are not filed, the taxpayers will receive a letter of proposed income tax adjustments and the amount due. If the IRS made a determination, taxpayers need to submit that information to the State of Michigan.

If taxpayers disagree with the information in the letter of inquiry, they should write to the Michigan Department of Treasury within the specified time. If they received a redetermination or any other documentation from the IRS, they should submit a copy of it attached to their letter.

TAXABILITY OF FEDERAL OBLIGATIONS

Income from certain U.S. Obligations, reduced by any expenses in carrying the obligation used in arriving at federal AGI, can be subtracted on the Michigan return.

The following U.S. Obligations are exempt from Michigan Individual Income Tax:

U.S. Government Bonds	U.S. Saving Bonds - Series E, F, G and H
U.S. Government Certificates	U.S. Treasury Bills and Notes

Obligations issued by the following U.S. Agencies are exempt:

Banks for Cooperatives	Federal Intermediate Credit Banks
Central Banks for Cooperatives	Federal Intermediate Credit Corp.
Commodity Credit Corp.	Federal Land Banks
Consolidated Bonds	Federal Land Banks Association
Consolidated Discount Notes	Federal Savings and Loan Insurance Corporation
Consolidated System Bond, Series L	Home Owner's Loan Corp.
Consolidated Systemwide	Joint Stock Land Banks
Discount Notes	Maritime Administration
District of Columbia	Production Credit Association
Farm Credit Banks	Small Business Administration
Farmers Home Corp.	Student Loan Marketing Association
Federal Deposit Insurance Corp.	(Sallie Mae)
Federal Farm Credit Bank	

Federal Farm Loan Corp.	Tennessee Valley Authority (bonds only)
Federal Farm Mortgage Corp.	U.S. Housing Authority
Federal Financing Banks	U.S. Maritime Commission
Federal Home Loan Banks	U.S. Possessions (obligations Puerto Rico, Virgin Islands, etc.)
Federal Housing Administration (General Insurance Fund Debentures)	U.S. Postal Service (bonds)

The following debentures issued under the General Insurance Fund are exempt:

Interest from Armed Services Housing Mortgage Debentures
 Interest from debentures issued under War Housing Insurance Law
 Interest from debentures to acquire rental housing projects

The following General Services Administration Public Building Trust Participation Certificates are exempt:

1st series A through E
 2nd series F
 3rd series G
 4th series H and I

The Guam Obligations issued by Government of Guam are exempt.

Notes: Income from **exempt** U.S. Obligations received by the taxpayer through Money Market Funds, Money Market Certificates, Mutual Funds, Trusts, etc., generally qualifies for a subtraction.

Treasury Bill Futures are **not** U.S. obligations.

The following U.S. Obligations are taxable:

Building and Loan Associations
 Credit Union Share Accounts
 District of Columbia Armory Board
 Export/Import Bank of Washington, D.C.
 Federal Home Loan Mortgage Corporation, (Freddie Mac) mortgages and other securities
 Federal Housing Administration (debentures, notes, and participation certificates)
 Federal National Mortgage Association (Fannie Mae) participation and other instruments
 Federal Savings and Loan Associations
 Government National Mortgage Association (Ginnie Mae) (debentures, notes, and participation certificates)
 International Bank for Reconstruction and Development (World Bank)
 Panama Canal Bonds
 Participation Certificates issued by the Federal National Mortgage Association
 Philippine Bonds
 U.S. Department of Agriculture Farmers Home Administration Insured Notes
 U.S. Government Insured Merchant Marine Bonds

Other examples of taxable interest from federal obligations:

Debentures issued to mortgages or mortgages foreclosed under the provisions of the National Housing Act
Farmer's Home Administration
Federal Home Loan time deposits
FSLIC secondary reserve prepayments
Government National Mortgage Association participation certificates and on Federal Home Loan Mortgage Corporation participation certificates in mortgage pools
Interest-bearing certificates issued in lieu of tax exempt securities, such income losing its identity when merged with other funds
Participating loans in the Federal Reserve System for member banks (Federal Funds)
Promissory notes of a federal instrumentality
Refunds of federal income tax
U.S. Postal Service certificates and savings deposits

Income Allocation

The following chart may be used to determine which types or sources of income are taxable to Michigan. This chart is not inclusive of all types of income, but reflects the most common.

<u>Type of Income</u>	<u>Allocate To</u>
Salaries, wages, tips, director fees, commissions, etc.	State where earned and state of residence. A Michigan resident may be entitled to a credit if income also taxed by another state. Exception: Residents of reciprocal states are not taxed by Michigan on this type of income and vice versa.
Deferred compensation: 1. Principal portion 2. Interest portion	Same as above, unless paid under Internal Revenue Code Sections 401(k), 457, 3121(v)(2)(c); then taxable to state of residence. (See Revenue Administrative Bulletin 1997-2 on Treasury's Web site at www.michigan.gov/treasury .) State of residence when received.
Dividends and interest	State of residence. Exception: If earned by a partnership or S corporation, allocate or apportion to the state of the business activity if business income.

<u>Type of Income</u>	<u>Allocate To</u>
Business income or loss (Schedule C)	State where business activity takes place. Business income attributable to Michigan and one or more states must be apportioned. (See Schedule H.)
Partnerships, S corporations or other flow-through entities income or loss:	
1. Ordinary business income or loss (Schedule E)	State where business activity takes place.
2. All other business income or loss	State where business activity takes place.
3. Nonbusiness income or loss	State of residence.
Capital gain or loss (Schedule D or 4797):	
1. Intangible personal property such as stocks, bonds, commodities, futures, etc.	State of residence unless business income.
2. Section 1231	State where property is located unless business income.
3. Real property	State where real property is located.
Pension, retirement, annuity, qualifying IRA distributions and Social Security benefits	State of residence when received.
Rent and royalty income or loss (Schedule E):	
1. Tangible and intangible personal property	Michigan if utilized in this state, or if a resident and not taxable in the state where property is utilized.
2. Real property (includes royalties for minerals which came from real property such as oil and coal)	State where real property is located.
Estate or trust income or loss	Look to type and source of income and apply guidelines in this chart.

<u>Type of Income</u>	<u>Allocate To</u>
Farm income or loss (Schedule F)	State where farm is located.
Unemployment compensation	State of residence.
Alimony, prizes, state and local refunds, and gambling winnings	State of residence when received. (Michigan Lottery won by nonresidents is taxable to Michigan.)

INCOME AND DEDUCTIBLE ITEMS, SUMMARY CHART

Notes: N = Not included:
Y = Included
AGI = Adjusted Gross Income
HHI = Household Income

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Alimony received	Y	Y	Y
Awards, prizes (in excess of \$300 for HHI)	Y	Y	Y
Bingo:			
First \$300 (Michigan)	Y	N	N
In excess of \$300 (Michigan)	Y	N	Y
First \$300 (from another state)	Y	Y	N
In excess of \$300 (from another state)	Y	Y	Y
Bonuses	Y	Y	Y
Business (Schedule C) income or loss:			
In Michigan (except Michigan oil and gas subject to severance tax)	Y	Y	Y
From another state and/or Michigan oil and gas subject to severance tax	Y	N	Y

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Capital gains:			
100% taxable	Y	Y	Y
Note: This subtraction is adjusted by the percentage increase in the U.S. Consumer Price Index for the preceding calendar year. See the MI-1040 instruction book for the year being reviewed.			
Senior citizen age 65 or older may subtract interest, dividends and capital gains included in AGI. The maximum deduction must be reduced by the pension subtraction. Allowable deduction is the smaller of the calculation or actual total interest, dividends and capital gains.			
	N	N	Y
Gains on sale of principle residence			
Casualty loss reimbursement in excess of loss of property	Y	Y	Y
Child support payments:			
Payer	Y	Y	Y
Receiver	N	N	Y
Chore service payments:			
Provider of service	Y	Y	Y
Receiver of service	N	N	N
Commissions	Y	Y	Y
Compensation for personal services rendered	Y	Y	Y
Damages for personal injury or sickness	N	N	Y
Deferred compensation	Y	Y	Y
Director's fees	Y	Y	Y
Disability income (limited)	Y	Y	Y
Dividends received (see Note under "Capital gains")	Y	Y	Y

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Educational expenses paid by employer	N	N	Y
Employee business expenses, cash allowance or reimbursement	Y	Y	Y
Energy assistance grants or tax credit	N	N	N
Estates or trusts income or loss	Y	Y	Y
<hr/>			
FIP benefits (see “Public assistance . . .”)			
Farm income or loss from:			
Michigan	Y	Y	Y
Another state	Y	N	Y
Farm portion of homestead property tax credit	Y	Y	N
Farmland preservation tax credits	Y	Y	Y
Foreign earned income exclusion	N	N	Y
Foster care payments	N	N	Y
<hr/>			
Gambling:			
Winnings (in excess of \$300 for HHI)	Y	Y	Y
Losses:			
Professional gamblers	Y	Y	Y
All others	N	N	N
Gifts - cash:			
First \$300	N	N	N
Excess over \$300	N	N	Y
Government grant for home repair or improvement	N	N	N
Government payments made directly to educational institutions or housing projects	N	N	N

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Health, life (unless benefits exceed \$50,000), and accident insurance premiums paid by employer	N	N	N
Homestead property tax credits	Y	N	N
Housing allowance for clergy	N	N	Y
<hr/>			
Inheritance bequest or devise from:			
Non-spouse	N	N	Y
Spouse	N	N	N
Interest received on:			
Banking, savings and loan assoc., etc., accounts	Y	Y	Y
Insurance dividends	Y	Y	Y
Land contracts	Y	Y	Y
Money market and savings certificates	Y	Y	Y
Municipal bonds issued by another state	N	Y	Y
Municipal bonds issued by Michigan	N	N	Y
Tax refunds	Y	Y	Y
U.S. Obligations (only specific agencies exempt)	Y	N	Y
Interest taxable to Michigan (see Note under “Capital gains”)			
<hr/>			
Life insurance proceeds paid to:			
Non-spouse	N	N	Y
Spouse	N	N	N
Life insurance - cash in amount in excess of premiums	Y	Y	Y
Living expenses of claimant paid by another person	N	N	Y
Loans received or paid	N	N	N
Long-term disability payments received (if all or part of premium paid by employer)	Y	Y	Y
Lottery:			
100% taxable (in excess of \$300 for HHI)	Y	Y	Y
Installment winners of Michigan lottery who won prior to 12-30-88	Y	N	Y

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Lump sum distribution included in 10-year averaging (for individuals born before 1936)	N	N	Y
Medicare payments	N	N	N
Military wages or retirements	Y	N	Y
Moving expenses, reimbursement:			
Moving into Michigan	Y	Y	Y
Moving out of Michigan	Y	N	N
Net operating loss deduction for household income (limited to federal modified taxable income)	Y	Y	Y
Partnership income or loss:			
In Michigan (except Michigan oil and gas subject to severance tax)	Y	Y	Y
From another state and/or Michigan oil and gas subject to severance tax	Y	N	Y
Private pensions or annuity plans (up to limitations for claimed year)	Y	N	Y
Note: This subtraction is adjusted by the percentage increase in the U.S. Consumer Price Index for the preceding calendar year. See the MI-1040 instruction book for the year being reviewed.			
Public assistance payments from FIA			
FIP paid to grandparents for care of grandchildren	N	N	Y
FIP paid to parents for children	N	N	Y
Public health officer's income:			
Michigan resident	Y	Y	Y
Nonresident	Y	N	N
Railroad sick pay	Y	Y	Y
Railroad Tier 1 retirement benefits:			
Taxable amount	Y	N	Y
Nontaxable portion	N	N	Y
Railroad Tier 2 retirement benefits	Y	N	Y

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Railroad unemployment benefits	N	N	Y
Refunds - Michigan state and local income tax	Y	N	N
Relief in kind	N	N	N
Rents and royalties income or loss:			
In Michigan (except Michigan oil and gas royalties subject to severance tax)	Y	Y	Y
From another state and/or Michigan oil and gas royalties subject to severance tax	Y	N	Y
Retirement benefits (see “Private pensions . . .”)	Y	N	Y
<hr/>			
S corporation business activity:			
In Michigan (except Michigan oil and gas subject to severance tax)	Y	Y	Y
In another state and/or Michigan oil and gas subject to severance tax	Y	N	Y
Scholarship, stipends, education grants, GI bill benefits	N	N	Y
Severance pay	Y	Y	Y
Sick pay	Y	Y	Y
Social Security benefits:			
Taxable amount	Y	N	Y
Nontaxable portion	N	N	Y
Stipends received for benefit of grantor (interns, resident doctors)	Y	Y	Y
Strike pay	Y	Y	Y
Supplemental gain (form 4797)	Y	Y	Y
Supplemental unemployment benefits	Y	Y	Y
Surplus foods	N	N	N

<u>Income Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Unemployment compensation	Y	Y	Y
Unemployment compensation from railroad	N	N	Y
Vacation allowance	Y	Y	Y
Veterans Administration benefits	N	N	Y
Wages, salaries, tips	Y	Y	Y
Worker's Compensation	N	N	Y
<u>Deductible Items</u>			
Alimony paid	Y	Y	Y
Capital losses:			
Short-term, maximum \$3,000 (HHI, maximum \$3,000)	Y	Y	Y
Long-term, maximum \$3,000 (HHI, maximum \$3,000)	Y	Y	Y
Casualty Loss:			
Claimed as itemized deduction	N	N	N
Claimed as business deduction	Y	Y	Y
"Claim of Right" (repayment of items previously included in income) taken as:			
Itemized deduction (taken as Michigan credit)	N	N	N
Federal tax credit (taken as Michigan credit)	N	N	N
Deduction reflected in AGI	Y	Y	Y
Health and accident insurance paid by taxpayer for self and family	N	N	Y
IRA or Keogh, (payments to)	Y	Y	Y
Moving Expenses:			
Moving to Michigan	Y	Y	Y
Moving out of Michigan	Y	N	N

<u>Deductible Items</u>	<u>AGI</u>	<u>Michigan Taxable Income</u>	<u>HHI</u>
Penalty on early withdrawal of savings	Y	Y	Y
Self-employment tax deduction	Y	N	Y

Michigan Cities Levying an Income Tax

The following Michigan cities levy an income tax of **1%** on residents and **0.5%** on nonresidents except those cities where rates are indicated:

Albion	Ionia
Battle Creek	Jackson
Big Rapids	Lansing
Detroit (for 2002 2.65% on residents, 1.325% on nonresidents; for 2003 2.55% on residents, 1.275% on nonresidents)*	Lapeer
Flint	Muskegon
Grand Rapids	Muskegon Heights
Grayling	Pontiac
Hamtramck	Port Huron
Highland Park (2% on residents, 1% on nonresidents)	Portland
Hudson	Saginaw (1.5% on residents, 0.75% on nonresidents)
	Springfield
	Walker

* After July 1, 1999, the maximum tax rate shall be reduced by 0.1% until the rate for residents is 2%. The tax rates for nonresidents shall be 50% of the rate for residents. The tax rate for all of 2004 through July 1, 2005 has been frozen at 2.5% for residents and 1.25% for nonresidents effective January 1, 2004.